No. 82-1592

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

MELVYN I. WEISS, Custodian for
GARY MICHAEL WEISS, U/NY/UGMA,

Petitioner,

—v.—

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES, INC., RUSSELL W. RITCHIE, ROBERT R. FORTUNE, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, and G. WILLING PEPPER,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED FOR REVIEW

Is the demand on directors requirement of Fed. R. Civ. P. 23.1 applicable to security holder suits under section 36(b) of the Investment Company Act of 1940? The question is comprised of two subquestions:

1. Does an investment company possess an implied right of action under section 36(b)?

2. If so, did Congress intend security holder actions under section 36(b) to be subject to the demand requirement of Rule 23.1?

This Court has recently granted a writ of certiorari to review these very same issues. *Fox v. Reich & Tang, Inc.*, 692 F.2d 250 (2d Cir. 1982), *cert. granted sub nom. Daily Income Fund, Inc. v. Fox*, ____ U.S. ____ (March 7, 1983).

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No. ____

IN THE

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OCTOBER TERM, 1982

MELVYN I. WEISS, Custodian for
GARY MICHAEL WEISS, U/NY/UGMA,

Petitioner,

—v.—

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES, INC., RUSSELL W. RITCHIE, ROBERT R. FORTUNE, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, and G. WILLING PEPPER,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioner, Melvyn I. Weiss, respectfully prays that a writ of certiorari issue to review that part of the judgment of the United States Court of Appeals for the Third Circuit entered on November 12, 1982, which affirmed a judgment of the United States District Court for the District of Delaware entered on June 17, 1981, dismissing petitioner's suit under section 36(b) of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. § 80a-35(b), for failure to comply with the demand on directors requirement of Rule 23.1 of the Federal Rules of Civil Procedure.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Third Circuit and the dissenting opinion of Judge Gibbons, dated November 12, 1982, are reported at 692 F.2d 928 and are reproduced in the Appendix to this petition at pages 1a to 29a and 29a to 48a, respectively.[1] The opinion of the United States District Court for the District of Delaware, dated June 17, 1981, is reported at 516 F. Supp. 665. (53a-68a.) A second opinion of the district court, dated August 27, 1981, denying petitioner's motion for reargument and for leave to file an amended complaint, is reported at 520 F. Supp. 1098. (71a-75a.)

JURISDICTION

The court of appeals issued its opinion and entered judgment on November 12, 1982. (49a-50a.) A petition for rehearing and suggestion for rehearing *en banc* was denied on December 30, 1982. (51a-52a.) This petition is filed within ninety days of the denial of the petition for rehearing. Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

The statute and rule involved are section 36(b) of the ICA and Rule 23.1 of the Federal Rules of Civil Procedure; both are reproduced in the Appendix. (79a-81a.)

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1 Hereafter, materials included in the Appendix will be referenced paranthetically as: (Xa-Ya).

STATEMENT OF THE CASE[2]

Petitioner is the custodian for a minority shareholder of the Temporary Investment Fund, Inc. (the "Fund"), a money market fund. Petitioner instituted this action under section 36(b) of the ICA against Provident Institutional Management Corporation ("PIMC"), the Fund's investment adviser, and Shearson Loeb Rhoades, Inc. ("Shearson"), the Fund's underwriter/distributor, to recover allegedly excessive fees paid by the Fund to PIMC and Shearson. The complaint acknowledged that no demand had been made upon the directors of the Fund, but asserted that demand on an investment company's directors is not a prerequisite for a section 36(b) security holder action against an investment company's adviser.

The defendants moved to dismiss the complaint on several grounds, including failure to satisfy the Rule 23.1 demand requirement. The district court dismissed the action, concluding that demand is a precondition to a section 36(b) shareholder suit. Having determined that demand was required in order to ensure that intracorporate remedies are exhausted prior to suit, the district court also denied petitioner's subsequent motion for leave to make a demand upon the Fund's directors and to file an amended pleading.

On appeal, a divided panel of the court of appeals held that the Rule 23.1 demand requirement is applicable to section 36(b) security holder actions and affirmed the judgment of the district court. The majority ruled that an investment company has an implied right of action against its investment adviser

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2 This statement of the case is taken from the circuit court's opinion, as relevant to the issues on this petition. Petitioner's complaint also alleged, against PIMC, Shearson, and the Fund's directors, other, related violations of federal securities and banking laws and state common law. Petitioner's complaint against James Louis Robertson, a director of the Fund, was dismissed by the district court for inadequate service of process. That dismissal was not appealed.

under section 36(b) and that Rule 23.1 applies to shareholder actions under section 36(b) because the right of the shareholder to sue is derived from the company's implied right. The majority further held that the language and legislative history of section 36(b) evidenced no Congressional intent to "bypass the directors." Judge Gibbons, in dissent, concluded that there was no support in section 36(b), its legislative history, or the prior relevant decisions of this Court for an implied corporate right of action under section 36(b) and that, to the contrary, the statute and this Court's prior decision in *Burks v. Lasker*, 441 U.S. 471 (1979), set forth a policy inconsistent with the application of Rule 23.1 to section 36(b) actions. A petition for rehearing *en banc* was denied.

REASONS FOR GRANTING THE WRIT

The decision of the court of appeals that shareholder actions under section 36(b) must comply with the demand on directors requirement of Rule 23.1 is in direct and irreconcilable conflict with a recent decision of the Court of Appeals for the Second Circuit on the same matter, *Fox v. Reich & Tang, Inc.*, 692 F.2d 250 (1982), *cert. granted sub nom. Daily Income Fund, Inc. v. Fox*, ____ U.S. ____ (March 7, 1983).[3] Since a petition for writ of certiorari has been granted in the Second Circuit case, granting this petition will not add to the burden of this Court. If this petition is denied, however, and if the decision of the Second Circuit is upheld, petitioner in this case will be left with the anomalous result of having this Court uphold his position, but having no remedy because he lost below. Petitioner, therefore, respectfully requests that his petition be granted and be consolidated for argument with *Fox*.[4]

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3 *Grossman v. Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, 459 U.S. ____, 103 S.Ct. 85 (1982), is another circuit court opinion on the same issue.

4 This Court's Rule 37.3 permits such consolidation. *See also Hillsboro Nat'l Bank v. Commissioner*, 455 U.S. 906 (1982) where certiorari was granted and cases consolidated for argument of common issues.

Further, the court of appeals has decided an important question of federal law—the interrelationship of Rule 23.1 and the Congressionally created security holder action under section 36(b) of the ICA—which has not been settled by this Court. The decision of the court of appeals has a dramatically limiting effect on the Congressional goal of protecting investment company shareholders from excessive advisory fees. The court of appeals' decision also contradicts the rationale of *Burks v. Lasker*, 441 U.S. 471 (1979), and, if permitted to stand, will undermine the important protections Congress mandated for investment company shareholders when it amended the ICA and added section 36(b).

Finally, the decision of the court of appeals rests upon a faulty premise: that an investment company has an implied right of action against its investment adviser under section 36(b). The premise is in error. It contradicts both the purpose and legislative history of section 36(b) and ignores this Court's recent rulings limiting creation of new implied rights of action under the securities laws.

Thus, this petition for a writ of certiorari should be granted because the decision below (1) creates a conflict between the circuits, (2) involves an important question of federal law which has not been settled by this Court, and (3) is erroneous and conflicts with the rationale of prior decisions of this Court.

ARGUMENT

I

Three federal courts of appeals have now decided the issue presented by this case. The Court of Appeals for the First Circuit held that a Rule 23.1 demand on directors is required in a shareholder action brought under section 36(b). *Grossman v. Johnson*, 674 F.2d 115, *cert. denied*, 459 U.S. ____, 103 S.Ct. 85 (1982). The Court of Appeals for the Second Circuit, after careful consideration, and noting its conflict with the First Circuit, unanimously held that since an investment company, itself, has no right of action under section 36(b), Rule 23.1 does not apply and no demand is required. *Fox v. Reich & Tang, Inc.*, 692 F.2d 250 (1982), *cert. granted sub nom. Daily Income Fund, Inc. v. Fox*, ____ U.S. ____ (March 7, 1983). In the opinion below, the Third Circuit, noting its conflict with the Second Circuit, held that investment companies do have an implied right of action under section 36(b), that Congress evidenced no intent to exempt section 36(b) actions from the provisions of Rule 23.1, and, thus, demand is required. Judge Gibbons, in a carefully reasoned opinion, dissented and generally agreed with the Second Circuit's *Fox* opinion.

The conflict between the circuits is clear, direct, and irreconcilable on this important question.

II

The decision below, if allowed to stand, will seriously undermine the central policy of protection for investment company security holders embodied in section 36(b) of the ICA, which was added to the ICA in 1970. The purpose of the amendment was to permit security holders of investment companies to bring actions to recover excessive advisory fees unimpeded by directorial interference.

The court of appeals stated that the 1970 amendments to the ICA were generally designed to strengthen the watchdog role of

unaffiliated directors of investment companies. It ignored extensive legislative history documenting Congressional awareness and concern that investment company directors were not and could not be effective checks against advisory fee abuses. Thus, the court of appeals erroneously concluded that imposition of Rule 23.1 requirements on section 36(b) actions would further the Congressional goal of strengthening the hand of the unaffiliated directors of investment funds.

The legislative history of the ICA, however, makes it clear that in enacting section 36(b) Congress was concerned exclusively with protecting shareholders' interests, notwithstanding the unaffiliated directors. The legislative history demonstrates Congressional awareness of the historic failure of even unaffiliated directors to protect shareholders with respect to advisory fees:

> It has been the Commission's experience in the administration of the Act that in general the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry.

Securities and Exchange Commission Report on "Public Policy Implications of Investment Company Growth," Report of the Committee on Interstate and Foreign Commerce, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 131 (1966).

Congress was also aware that the failure was not historic happenstance, or caused by lack of directorial power or venal motivation, but was structural:

> The unaffiliated directors, as the only potentially disinterested persons in the management of most investment companies, can and should play an active role in representing the interests of shareholders not only in connection with management compensation but in other areas where the interests of the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to the protection of public shareholders. But even a requirement

> that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation.
>
> The unaffiliated directors are not in a position to bargain on an equal footing with the adviser on matters of such crucial importance to it. They are not free, as a practical matter, to terminate established management relationships when differences arise over the advisory fees or other compensation. This reflects, in large part, the adviser-underwriter permeation of investment company activities to an extent that makes rupture of the existing relationships a difficult and complex step for most companies. For these reasons, arm's-length bargaining between the unaffiliated directors and the managers on these matters is a wholly unrealistic alternative.

Id. at 148.

Congress added section 36(b) to the ICA to remedy the problem:

> In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.
>
> Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the courts to act where *mutual fund shareholders or the SEC* believe there has been a breach of fiduciary duty. This bill would make it clear that, as a matter of Federal law, the investment adviser or mutual fund management company has *a fiduciary duty with respect to mutual fund shareholders.* It provides an effective method whereby the courts can determine whether there has been a breach of this duty by the adviser or by

> certain other persons with respect to their compensation from the fund.

Report of the Senate Committee on Banking and Currency, S. Rep. No. 184, 91st Cong., 1st Sess. 2 (1969) (emphasis added).

This Court has already held in recognition of the relative impotence of investment company directors in dealing with advisory fee questions that section 36(b) claims are not subject to the business judgment rule. They cannot be dismissed or circumscribed by board action:

> [W]hen Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), . . . , performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees.

Burks v. Lasker, 441 U.S. at 484 (citations and footnote omitted).

The proper relationship between Rule 23.1 and section 36(b) is not a hollow issue of procedural nicety without substantive implications. It relates directly to the control mutual fund management will have over section 36(b) actions.

The court below felt that shareholder exhaustion of intracorporate remedies, even in the absence of directorial power to terminate the claim, gave purpose to the Rule 23.1 demand requirement for section 36(b) actions. But the one year statute of limitations provided in section 36(b)(3) argues strongly against allowing the routine delays inherent in the Rule 23.1 demand process.[5] Such delays, particularly if post-suit demand is not allowed, as the circuit court held below (29a), may result in significant diminution of recoveries, contrary to Congress' purpose, merely to support the chimerical hope that the directors will, upon demand, do what the Congress found them

5 In the *Grossman* case, 674 F.2d 115, the record on appeal indicates that despite an order of the district court directing a prompt response to plaintiff's post-complaint demand, over six months elapsed until the investment company's board rejected the demand. Such delays in responding to a demand are not unusual. In the *Fox* case, the Second Circuit discussed this issue, 692 F.2d at 261-2.

structurally incapable of doing—adequately resolving, intra-corporately or otherwise, advisory fee abuses.

The issue is an important federal question which this Court should resolve.

III

The central error in the decision below is its holding that an investment company has an implied private right of action under section 36(b). The court of appeals' inference of a new implied right of action, while essential to its holding, defies logic and completely contradicts both this Court's prior decisions regarding implied private rights of action and the legislative history of section 36(b).

This new implied right of action was created by the court of appeals solely for the purpose of requiring a Rule 23.1 demand here. Congress did not see fit to legislate such a claim. To date, not one reported case exists where a mutual fund or its directors have attempted to assert such a claim. Nevertheless, the court below, solely in order to bring the shareholder claim within the ambit of Rule 23.1, created this implied corporate claim. It then asserted that the section 36(b) shareholder claim was derived from that new implied claim. In fact, the only claim Congress created was a new action granting investment company shareholders direct, not derivative, access to federal courts. Congress did not deem it necessary to traverse the circuitous route of deriving that claim from a corporate right. Neither should the courts.

Rule 23.1 applies only to "a derivative action brought by one or more shareholders . . . to enforce a right of a corporation . . . the corporation . . . having failed to enforce a right which may properly be asserted by it . . ." A shareholder's action to recover for his investment company excessive advisory fees is governed by Rule 23.1 only if such investment company may properly assert an action itself, or through its directors, under section 36(b) and if the shareholder's action is derived from such company action. But section 36(b) only

provides for "[a]n action . . . under this subsection by the Commission or by a security holder of such registered investment company on behalf of such company. . . ."

Recent decisions of this Court teach that, absent a strong indication of Congressional intent to the contrary, courts should not read implied rights of action into a statute which expressly provides for only particular statutory actions. *Middlesex County Sewerage Authority v. National Sea Clammers Association*, 453 U.S. 1, 13 (1981); *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 639 (1981). This is particularly so with respect to federal securities regulation. *Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11 (1979); *Touche Ross & Co. v. Reddington*, 442 U.S. 560 (1979); *Piper v. Chris-Craft Industries*, 430 U.S. 1 (1977).

The court of appeals majority claims that the new implied right of action it finds under section 36(b) falls within the exception recognized by this Court in *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, ____ U.S. ____, 102 S. Ct. 1825 (1982). But, as Judge Gibbons points out in dissent, *Curran* is quite to the contrary. In *Curran* this Court was asked to determine whether previously implied rights of action under the Commodity Exchange Act survived or would be rejected as a result of the 1974 amendments to that statute which had made substantial changes in the statutory scheme, including the addition of new statutory remedies, but which had left intact the provisions under which the courts had previously implied rights of action. This Court held that since Congress was aware of the earlier judicially implied rights of action and expressed no desire to eliminate them, one could infer that by not repealing the implied rights Congress intended to retain them.

Section 36(b), on the other hand, was newly codified by the 1970 amendments. It created a totally new cause of action with carefully crafted standards and a very short statute of limitations. There was no previous judicial record recognizing implied rights of action under section 36(b) prior to the 1970

amendments because it did not yet exist.[6] *Curran*, therefore, offers no assistance to the court of appeals in discovering an implied right of action under a new section creating a limited new cause of action, and is, indeed, to the contrary.

Finally, the court of appeals' opinion does not offer even one reason why Congress might have intended to *imply* a new corporate cause of action when it could simply have added investment companies, their directors, or even their unaffiliated directors to the list of statutorily recognized plaintiffs.

Conversely, there are many cogent reasons why Congress did not permit investment companies to assert section 36(b) claims. First, the legislative history, as pointed out in both the majority and dissenting opinions below, reflected Congressional concern that board action had been ineffective with respect to restraining advisory fees in the past and that there was no reason to expect improvements in the future, because the ineffectiveness was structural.

Second, as Judge Gibbons suggests in dissent, Congress may have not given the company or its directors a claim in order to avoid situations where fund directors might try to pre-empt SEC or shareholder action with "sweetheart" litigation between boards and advisers.

Third, the statute itself indicates that Congress did not expect, or intend, that section 36(b) claims be raised by

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6 Implied rights of action under the ICA were recognized by the courts before the 1970 amendments under previously enacted sections of the ICA prohibiting waste, conversion, gross misconduct, etc. *Esplin v. Hirschi*, 402 F.2d 94 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969); *Levit v. Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Taussig v. Wellington Fund, Inc.*, 313 F.2d 472 (3d Cir. 1963), *cert. denied*, 374 U.S. 806 (1963); *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961). Such implied rights of action were found under sections 15, old 36 (which became 36(a) in the 1970 amendments), 37 and 48, and, in light of *Curran*, would appear to continue with the same vitality after the 1970 amendments. *Jerozal v. Cash Reserve Management, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 99, 019 (S.D.N.Y. Aug. 10, 1982). The existence of these implied rights of action before the 1970 amendments should not, however, cause the courts to imply a new right of action under section 36(b).

investment companies: Section 36(b)(2) directs courts hearing claims arising under the section to give "such consideration . . . as is deemed appropriate" to board approval and shareholder ratification of challenged fee arrangements. Such a proviso, which applies to *all* claims under the section, is obviously directed to non-board challenges to fee agreements—*i.e.*, challenges by the SEC or by shareholders—and not, at least not in any way that makes sense or can be fitted into the legislative scheme, to actions by the company itself.

The court of appeals erred by creating a new implied right of action under section 36(b) in the total absence of statutory language or legislative history supporting such an implied right. Even the majority below appears to concede that without such an implied corporate right of action a shareholder's section 36(b) action does not seek "to enforce a right which may properly be asserted by" his investment company, and, thus, a Rule 23.1 demand is not required.

The judgment of the court of appeals is erroneous and contrary to this Court's prior decisions.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to the United States Court of Appeals for the Third Circuit.

Respectfully submitted,

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March 24, 1983

APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 81-2688

MELVIN I. WEISS, Custodian for GARY MICHAEL WEISS, U/NY/UGMA,

Appellant,

—v.—

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES, INC., RUSSELL W. RICHIE, ROBERT R. FORTUNE, JAMES LOUIS ROBERTSON, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, G. WILLING PEPPER,

Appellees.

(D.C. Civil No. 80-00230)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF DELAWARE

Argued April 2, 1982

Before:

GIBBONS, SLOVITER and BECKER,

Circuit Judges.

(Opinion Filed November 12, 1982)

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OPINION OF THE COURT

BECKER, Circuit Judge.

The principal question presented in this appeal is whether a shareholder of an investment company must make a demand on directors pursuant to Fed. R. Civ. P. 23.1 prior to commencing suit under section 36(b) of the Investment Company Act of 1940 (ICA), 15 U.S.C. §§ 80a-35(b)(1976), to challenge the company's contracts with its investment advisers. The district judge dismissed the action for failure to satisfy the demand requirement, *Weiss v. Temporary Investment Fund, Inc.*, 516 F.Supp. 665 (D. Del. 1981), and denied the appellant leave to replead after making a demand, *Weiss v. Temporary Investment Fund, Inc.*, 520 F.Supp. 1098 (D. Del. 1981).

Appellant Weiss contends that the ICA was a product of Congress' recognition of potential conflicts of interest in the management of investment companies and that the ICA's

legislative history and statutory scheme, which reflect that concern, are inconsistent with the requirement of shareholder demand. After reviewing that legislative history and statutory scheme and the purposes of the demand requirement, we perceive no such inconsistency. We conclude that the contributions of the demand requirement to corporate governance mandate application of Rule 23.1 to section 36(b) suits. We also conclude that the circumstances alleged in the complaint do not warrant excusing such a demand as futile, and the district judge did not err in denying leave to replead. We therefore affirm.

I. INTRODUCTION

A. Factual and Procedural Background

Plaintiff-appellant Melvyn I. Weiss, as custodian for his son Gary Michael Weiss, is a shareholder of the Temporary Investment Fund, Inc. (the Fund). The Fund is a no-load open-end investment company, commonly referred to as a "money market fund," whose objective is to increase the current income of its shareholders through investments in a variety of prime money market obligations. The Fund is managed by a seven-member board of directors elected by its shareholders.[1]

Under an Advisory Agreement, the management of the Fund's portfolio is entrusted to its investment adviser, Provident Institutional Management Corporation (the Adviser), a wholly-owned subsidiary of Provident National Bank (Provident). Under a sub-advisory agreement, Provident receives seventy-five percent of the Adviser's fees, in return for which it supplies, *inter alia*, investment research services, computer facilities, and operating personnel. Shearson Loeb Rhoades, Inc. (Shearson) serves as underwriter for the Fund and performs other administrative functions under its Administration and Distribution Agreement with the Fund.

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1 In January 1980, when the advisory contracts at issue were approved, the board consisted of six members.

The terms of the Advisory and Administration Agreements (collectively referred to as "advisory contracts") provide that the fees received by the Adviser and Shearson are computed as a percentage of the Fund's assets. The percentage rate is scaled downward: Shearson and the Adviser each received .175 percent of the first $300 million in assets, .15 percent of the next $300 million, and .125 percent of the third $300 million. For average net assets in excess of $900 million, the rate is fixed at .1 percent. The recent popularity of money market funds has dramatically increased the Fund's assets, to more than $2 billion when suit was commenced in 1980. This phenomenon has produced a commensurate increase in the fees received by the Adviser and Shearson.

On May 7, 1980, Weiss brought a shareholder suit on behalf of the Fund against the Adviser, Shearson, and seven directors of the Fund. One count of the complaint charges that Shearson and the Adviser breached their fiduciary duties to the Fund under section 36(b) of the ICA by receiving "excessive and unreasonable" compensation. The basis of this count is the advisory contracts, which Weiss contends permit the Adviser to receive twenty-five percent of the fees without performing any services and fail to provide for any reduction in fees after the Fund's assets exceed $900 million. Additional counts allege that all defendants breached their fiduciary duties by participating or acquiescing in the advisory contracts; that shareholder approval of the fee arrangements was secured through misleading proxy statements in violation section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(n)(a)(1976); and that the management and fee arrangements violate the Banking Act of 1933, 12 U.S.C. §§ 24, 378(a)(1976), the ICA, and common law fiduciary duties. As relief, the plaintiff sought a judgment declaring the Advisory Agreement and the Distribution Agreement void, an order requiring that the Adviser and Shearson repay all excessive fees to the Fund, and an order requiring the individual defendants to reimburse the Fund for damages caused by their violations of the ICA and the Securities Exchange Act.

The complaint acknowledges that no demand was made on the directors of the Fund. It asserts, however, that demand is not a prerequisite for the section 36(b) count and that demand would have been futile as to all counts because the directors are controlled by the Fund's advisers and because they participated in the alleged violations. Amended Complaint at ¶ 37.

The defendants moved to dismiss the complaint on a number of grounds, including the plaintiff's failure to satisfy the Rule 23.1 demand requirement. The district court, concluding that demand is required for a section 36(b) suit and was not excused as futile, dismissed the complaint.[2] Having determined that intra-corporate remedies should be exhausted first, the court found it unnecessary to address the other challenges to the complaint. The court subsequently denied Weiss' motion seeking leave to make a demand on the directors and to file an amended complaint if demand was refused. Weiss appeals from all three rulings.

As we indicated at the outset, section 36(b) is the principal focus of our attention. Its relevant portions are set forth in the margin.[3] Although section 36(b) does not explicitly excuse

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2 The court also dismissed the action against defendant James L. Robinson for insufficient service of process. That portion of the district court's order has not been appealed.

3 Section 36(b) provides, in relevant part:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

shareholders from the demand requirement of Rule 23.1, Weiss advances two theories to support his position that demand is not required. First, he argues that because the statute does not authorize a cause of action by the corporation, a section 36(b) suit is not derivative and is thus not governed by Rule 23.1 at all. Alternatively, he asserts that the legislative history and the statutory scheme supersede the policies underlying the requirement of shareholder demand. Although he presents a number of discrete arguments to support this latter thesis, their common predicate is that Congress, perceiving directors of investment companies to be ineffective checks on advisory fee levels, structured section 36(b) to permit shareholders to bypass the directors. Before considering Weiss' specific contentions, we must describe the contours of section 36(b) and other relevant provisions of the ICA.

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(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratifications or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

15 U.S.C. § 80a-35(b)(1976)

B. The Statutory Scheme

The management of an investment company is distinguished by its reliance on external management and investment advisers. *See, e.g., Burks v. Lasker*, 441 U.S. 471, 480-85 (1979); *Tannenbaum v. Zeller*, 552 F.2d 402 (2nd Cir.), *cert. denied*, 434 U.S. 934 (1977); Note, *Mutual Fund Independent Directors: Putting a Leash on the Watchdogs*, 47 Fordham L. Rev. 568 (1979) [hereinafter cited as Fordham Note]. Typically, an external organization such as Shearson creates the investment fund and appoints the initial board of directors. The board then enters into a contract with one or more external companies who manage the fund and provide investment services. In addition to receiving fees for these two functions (which may be performed by the same outside adviser), the independent advisers may receive underwriting fees or brokerage commissions if they also serve in those capacities. This web of financial ties among the fund and its advisers invites several conflicts of interest. In negotiating advisory fees, for example, directors affiliated with the adviser face the competing interests of the adviser, who seeks high fees, and the investors, who want low fees in order to maximize their return on investment. Similarly, an adviser who also serves as broker has an incentive to increase its fees through frequent portfolio transactions that may dissipate the earnings of the investors. *See* Fordham Note, *supra* p. 7, at 570-71.

The ICA was intended to minimize the potential conflicts arising from the creation, sale, and management of an investment company such as a mutual fund by external investment advisers. S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901. As originally enacted in 1940, the ICA's principal device to prevent self-dealing by the directors was the requirement that at least forty percent of the board members be independent—that is, that they have neither a direct nor an indirect financial interest in the company or its adviser. 15 U.S.C. § 80a-10(a)(1976). Over time, however, it became apparent that this safeguard was insufficient to stem the burgeoning advisory fees. Recognizing

that a company's dependency on its adviser limited the influence of arms-length bargaining in keeping advisory fees competitive, Congress enacted section 36(b) as part of the 1970 amendments to the ICA. That section imposes on the adviser a fiduciary duty with respect to compensation for its services and explicity authorizes suits by the Securities and Exchange Commission and the fund's shareholders to enforce that duty. By increasing the standard of care owed by the advisers, Congress sought to ease the difficult burden faced by shareholders trying to prove that advisory contracts violated common law prohibitions against "corporate waste." *See infra* note 9. The remedy under 36(b) is an action against the recipient of the allegedly excessive payments for actual damages resulting from the breach of fiduciary duty, not to exceed actual payments received from the investment company. A showing of personal misconduct by the defendant is not required. The recovery of excessive fees is limited to those paid by the investment company during the one-year period prior to initiation of the suit.

Additional responsibility for monitoring management fees were also imposed on directors. The 1970 amendments require directors to investigate and evaluate advisory fee contracts, demand that a majority of disinterested directors approve the contracts, and permit the directors to terminate contracts without financial penalty upon sixty days' notice. 15 U.S.C. § 80a-15(c) (1976). The amendments also tightened the qualifications of the independent directors serving on the board. *Id.* §§ 80a-2(19), 80a-10a.[4] The essence of the amendments, as the Supreme Court has noted, is to place these unaffiliated directors in the role of "independent watchdogs" charged with supervising the management of the company. *Burks v. Lasker, supra*, 441 U.S. at 484.

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4 Independent directors are those who are not "interested" in the company or its advisers. The amendments define "interested person" to include persons who have close family ties or substantial financial or professional relationships with the investment company or its advisers, or who have beneficial or legal interests in securities issued by the adviser or underwriter.

With this background in mind, we turn to Weiss' arguments that suits under section 36(b) are not subject to Rule 23.1.

II. IS A SECTION 36(b) ACTION DERIVATIVE?

Before addressing the arguments set forth in the briefs, we must consider a threshold contention—advanced by Weiss for the first time at oral argument—that a shareholder suit under section 36(b) is not a derivative action and thus not subject to Rule 23.1.[5]

Weiss apparently relies on the rule's requirement that the right enforced by a shareholder by one which "may properly be asserted" by the corporation.[6] The ICA, however, explicitly authorizes suits only by the SEC and by the shareholders and does not state that the Fund itself may sue its advisers for breach of fiduciary duties. If the Fund cannot sue, Weiss' theory proceeds, then a section 36(b) cause of action does not derive from a right that "may properly be asserted" by the Fund. We disagree.

We can approach this issue in several ways. One approach, adopted by the First Circuit in *Grossman v. Johnson*, 674 F.2d 115 (1st Cir. 192), *cert. denied*, 51 U.S.L.W. 3245 (U.S. Oct. 5, 1982), views an investment company's right to sue its advisers

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5 The belated nature of this argument is evidenced by Weiss' pleadings, which characterize the action as one brought "derivatively on behalf of the Fund." Amended Complaint at ¶ 2(b).

6 Rule 23.1 states in pertinent part:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation, . . . the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and the reasons for his failure to obtain the action or for not making the effort.

The Rule establishes other derivative suit requirements such as contemporaneous ownership of stock by the plaintiff when the alleged wrong occurred. These additional requirements are not at issue in this appeal and references here to "Rule 23.1" are limited to the demand requirement unless otherwise noted.

as a necessary, if not explicit, corollary of the right of action conferred on shareholders by section 36(b). In holding that an investment company has a direct cause of action under section 36(b), the *Grossman* court stated:

> We cannot believe . . . that, for example, a new and independent board of directors, intent on recovering excessive fees from the investment adviser, would be precluded from suing under section 36(b). That section is explicit that recovery by a shareholder is to be on behalf of the investment company and that his suit must be brought on the same behalf. With those clear requirements, Congress could well have believed that, though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action under section 36(b), *see Moses v. Burgin*, 445 F.2d 369, 373 n.7 (1st Cir. 1971), it was unnecessary to say with particularity that the company also did. A suit 'on behalf of such company' (a phrase which is more than merely one 'for the benefit of the company') is normally a derivative action that company itself could bring.

Id. at 120 (footnotes omitted).[7] Along similar lines, the Supreme Court noted in *Burks v. Lasker, supra*, 441 U.S. at 477, that "[a] derivative suit is brought by shareholders to enforce a claim *on behalf of* the corporation" (emphasis supplied), and the Court thereafter referred without comment to a section 36(b) suit as derivative, *id.* at 484.

We agree with the First Circuit's reasoning as far as it goes, but we expand our analysis to consider the test enunciated in *Cort v. Ash*, 422 U.S. 66 (1975). *Cort* provides the generally accepted framework for determining whether a statute creates an implied right of action.[8] Our application of the *Cort* test leads us to the same conclusion as the First Circuit.

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7 The Second Circuit has rejected this argument. Fox v. Reich & Tang, Inc., No. 82-7296 (2d Cir. October 26, 1982); *see infra* pp. 13-14.

8 We recognize that implication of the corporation's right of action by a statute expressly authorizing suit by shareholders is somewhat atypical of

Cort counsels consideration of four factors:

> First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,'—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law.

Cort v. Ash, supra, 422 U.S. at 78 (citations omitted). With respect to the first factor, we have no difficulty in concluding that an investment company is the intended beneficiary of section 36(b). The legislative history states that the fiduciary duty imposed on advisers, one of the major innovations of the statute, is owed to the company itself. S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4902. Moreover, as Weiss concedes, any recovery obtained in a shareholder suit reverts to the investment company and not to the plaintiff.

The second factor, ascertainment of Congress' intent, is the principal focus of the *Cort* inquiry. *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825, 1839 (1982); *see Walck v. American Stock Exchange, Inc.*, No. 82-1051, slip

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the cases employing the *Cort* test. Three recent Supreme Court opinions illustrate the usual application of the *Cort* test in situations where the statute fails to specify either a private remedy or a cause of action for the particular relief sought. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825 (1982) (finding private rights of action for violations of the Commodity Exchange Act); Middlesex County Sewerage Authority v. National Sea Clammers Ass'n, 453 U.S. 1 (1981) (finding no implied private right of action for damages under the Federal Water Pollution Control Act or the Marine Protection, Research, and Sanctuaries Act of 1972); Texas Industries, Inc. v. Radcliff Materials, Inc., 451 U.S. 630 (1981) (antitrust laws to not give rise to implied right of contribution).

op. at 6, 10 (3d Cir. Sept. 1, 1982). We find nothing in the legislative history of the ICA that suggests an intent to deprive the company of a direct remedy. Neither, we must concede, do we find an explicit expression by Congress that the investment company is authorized to sue its adviser. But our conclusion is unaffected by this absence of express authorization for, as the Supreme Court noted in canvassing the same legislative history, silence regarding the powers of the board of directors to be expected: "The ICA does not purport to be the source of authority for managerial power; rather, the Act functions primarily to 'impos[e] *controls and restrictions* on the internal management of investment companies.' " *Burks v. Lasker, supra*, 441 U.S. at 478 (citation omitted) (emphasis in original). Thus we may properly infer from this legislative silence that Congress did not intend to restrict the company's right to sue.

The state of the law at the time of the 1970 amendment supports this construction of the legislative history. We are required to look at this "contemporary legal context" to determine whether the company had a right to sue when the statute was enacted. If such right existed, we need only determine whether Congress intended to preserve the preexisting remedy. *See Merrill Lynch, Pierce, Fenner & Smith v. Curran, supra*, 102 S. Ct. at 1839. In this regard, we agree with the district court's observation, *see* 516 F. Supp. at 670 n.11, that the company possessed (and still possesses) a cause of action against the adviser at common law.[9] We also note that a shareholder's right to sue *derivatively* was implied by former

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9 The common law predecessor to section 36(b) action was a suit against the adviser for "corporate waste," an action traditionally deemed to be derivative. 13 W. Fletcher, *Cyclopedia of the Law of Private Corporations* ¶¶ 5924, 5926, 5927 (rev. perm. ed. 1980). Congress found the burden of proving corporate waste "unduly restrictive" and created the fiduciary duties in section 36(b) to reduce the burden of invalidating advisory contracts. S. Rep. No. 184, 91st Cong., 1st Sess. 5(1969), *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901. Because the common law action was derivative, we assume Congress expected the federal action to be derivative as well.

section 36 (now section 36(a)), which authorizes SEC enforcement of the ICA's regulatory scheme. *See, e.g., Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971) (finding implied right of action under former section 36 for shareholder to sue derivatively to recapture excessive brokerage fees paid by the mutual fund). "Where Congress adopts a new law incorporating sections of a prior law, Congress can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute." *Merrill Lynch, Pierce, Fenner & Smith v. Curran, supra*, 102 S. Ct. at 1841 n.66. Against this legal backdrop at the time of the amendments, Congress' assumption that the shareholder suit was derivative from the company's right of action becomes clear, as does the correctness of the First Circuit's conclusion that Congress assumed the company enjoyed a direct cause of action and there was no need to so specify. In sum, the second *Cort* criterion is met for the reasons set forth by the First Circuit in *Grossman* and because we find no evidence of a Congressional intent to deprive the company of its right to sue the company's adviser.

The third and fourth factors of the *Cort* test follow ineluctably from the preceding discussion. Providing the investment company with a cause of action fully accords with the purposes of section 36(b) by providing another means to recover excessive advisory fees. From a practical standpoint, in fact, the company's financial resources and knowledge of the challenged transaction may render it an even more effective litigant than the shareholder. Finally, the express cause of action conferred by Congress upon shareholders *ipso facto* federalizes this type of litigation; hence implication of a companion remedy for the investment company does not intrude upon an area "traditionally relegated to state law." Thus application of the four-pronged test of *Cort v. Ash* compels us to conclude that the investment company has a cause of action against the advisers for breach of the fiduciary duties imposed by section 36(b). We are aware that the Court of Appeals for the Second Circuit recently reached the opposite conclusion. *Fox v. Reich*

& Tang, Inc., No. 82-7296 (2d Cir. Oct. 26, 1982). After careful consideration of the court's reasoning, however, we remain convinced that the investment company has a cause of action and that a § 36(b) action is derivative.

III. IS SECTION 36(b) CONSISTENT WITH THE DEMAND REQUIREMENT?

Even if a section 36(b) suit is derivative, Weiss insists that the ICA excuses such suits from Rule the 23.1 demand requirement. As we have noted, he concedes that the statute does not do so expressly, but contends that the legislative history and statutory scheme of section 36(b) manifest Congress' intent to eliminate this prerequisite to suit.

At the outset we note that Weiss must overcome the presumption the Rule 23.1, like all Federal Rules of Civil Procedure, applies to any civil suit brought in federal district court unless inconsistent with an Act of Congress. Fed. R. Civ. P. 1; *see* 28 U.S.C. § 2071 (1976). Abrogation of a rule of procedure generally is inappropriate "[i]n the absence of a direct expression by Congress of its intent to depart from the usual course of trying 'all suits of a civil nature' under the Rules established for that purpose." *Califano v. Yamasaki*, 442 U.S. 683, 700 (1979). Repugnancy of a statute to a civil rule is not to be lightly implied. Rather, "a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." *Grossman v. Johnson, supra*, 674 F.2d at 122-23 (quoting 7 *Moore's Federal Practice* ¶ 86.04[4] at 86-22 (2d ed. 1980)); *accord Fox v. Reich & Tang, Inc.*, 94 F.R.D. 94 (S.D.N.Y. 1982), *rev'd on other grounds*, No. 82-7296 (2d Cir. Oct. 26, 1982).

A. Does the Legislative History Reflect Congress' Intent to Require Demand?

Weiss relies on the legislative history accompanying the 1970 amendments, passages of which reflect Congress' perception that even unaffiliated directors had not been able to secure changes in the advisory fee levels. For example, he quotes from

the Securities and Exchange Commission Report on Investment Companies, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966):

> It has been the Commission's experience in the administration of the Act that in general *the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry.*
>
> . . .
>
> The analysis of the shareholder fee litigation not only underscores the need for changes in existing statutory provisions relating to management compensation in the investment company industry, but points to the direction which these changes should take. It makes clear the need to incorporate into the Act a clearly expressed and readily enforceable standard that would measure the fairness of compensation paid by investment companies for services furnished by those who occupy a fiduciary relationship to such companies.
>
> . . .
>
> The right of the *Commission as well as investment company shareholders* to take action against violations of the *statutory standard of reasonableness* is essential to effective enforcement.

Id. at 131, 143, 146 (emphasis supplied by appellant). Second, he invokes the Congressional intention to establish a mechanism by which the shareholders and courts could enforce the investment adviser's fiduciary duty. The report accompanying the 1970 amendments states:

> In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.
>
> Therefore your committee has adopted the basic principal that, in view of the potential conflicts of interest involved

> in the setting of these fees, *there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty.*

S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4898 (emphasis supplied by appellant).

These passages do not reflect a "direct expression by Congress" of its intent to eliminate the demand requirement. Expressions that shareholders and the SEC need increased judicial access in order to insure the reasonableness of advisory fees do not denote an intent to bypass the directors completely. On the contrary, the legislative history is replete with references to Congress' intent to preserve, not preempt, the role of management in negotiating advisory fees. The Senate Report emphasizes this point:

> [Section 36(b)] is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees. . . . Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.

S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4902-03. The clear intent of Congress was to install management as "the first line of defense for the individual investor" against any self-dealing by the adviser. *Fox v. Reich & Tang, Inc., supra*, 94 F.R.D. at 96. As the Supreme Court noted in *Burks v. Lasker, supra*, 441 U.S. at 484-85, the 1970 amendments were designed to place the unaffiliated directors in a "watchdog" role. Requiring that

shareholders make a demand upon the directors is fully consonant with this purpose.

Requiring demand also accords with the legislative history, which itself alludes to the continued operation of the demand requirement. During Congressional hearings on the proposed amendments to the ICA, then SEC Chairman Hamer Budge assured the committee that providing shareholders with a cause of action would not encourage nuisance suits: "As we have pointed out previously, there are adequate safeguards under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation." *Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. of Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. 201 (1969); *accord id.* at 860. It is clear to us that this statement refers to Rule 23.1 and its demand requirement. Contrary to Weiss' suggestion, the legislative history reflects an implicit understanding that Rule 23.1 would apply—an understanding which comports with the purposes of Section 36(b).

B. Is the Statutory Scheme Consistent with the Requirement of Shareholder Demand?

Weiss' final arguments regarding the alleged inapplicability of Rule 23.1 spring from his contention that the structure of section 36(b) is inconsistent with the requirement of shareholder demand, and that Congress therefore did not contemplate demand as a prerequisite to suit. Weiss make three arguments. The first two require only brief discussion; the third merits more extensive treatment.

1. *The Effect of the One-Year Limitation on Recovery*

Weiss asserts that demand cannot be required because: (1) section 36(b) limits the recovery of unreasonable fees to those that were paid during the one-year period prior to commencement of suit; (2) once a shareholder plaintiff makes a demand, the directors can delay a response while the excessive fees continue to be paid; and (3) Congress could not have intended

to interpose the demand requirement because the time consumed by the directors in responding to demand would time-bar claims to recover fees paid out by the investment fund. At least one court has indentified this statutory provision as a basis for suggesting, in dictum, that demand should not be a prerequisite to a section 36(b) suit. *See Blatt v. Dean Witter Reynolds Intercapital, Inc.*, 528 F. Supp. 1152, 1155 (S.D.N.Y. 1982).

We recognize that in some cases, demand will postpone the filing of suit and thereby move forward the one-year period allowed for the recovery of fees. In most instances, however, this will not reduce the allowable recovery. In any event, we do not see why demand cannot be promptly made and expeditiously considered.[10] Notwithstanding Weiss' intimations to the contrary, demand is a simple procedure that is not burdensome to the shareholders. We therefore do not believe that the one-year limitation period compels the conclusion that Congress intended to eliminate the demand requirement.[11]

2. *The Analogy to Section 16(b) of the Securities Exchange act of 1934*

Weiss advances a somewhat tortured analogy between section 36(b) of the ICA and section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1976), which allows shareholders to recover illegal insider "short swing" profits. Suits brought under section 16(b) are exempt from the contemporaneous ownership requirement of Rule 23.1 *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954). Weiss perceives similarities between insider trading

10 The First Circuit, in rejecting the identical argument, suggested that the district court could allow suit to go forward without waiting for a response if the directors unduly postpone a response to demand. *Grossman v. Johnson*, *supra*, 674 F2d at 122. We intimate no view here concerning the propriety of that suggestion.

11 Additionally we note that the short statute of limitations may reflect a Congressional view of the ICA as designed to ameliorate the situation prospectively rather than to establish a long damage period.

and "insider" advisory fees. He suggests that section 36(b), like section 16(b), is an instrument of public policy which should not be hampered by procedural restrictions such as the demand requirement of Rule 23.1.

Without reaching the merits of the statutory analogy, we simply note that it is irrelevant: suits to recover short swing profits under section 16(b) are subject to the demand requirement by the very terms of that statute, which states that a shareholder may institute an action "if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter." 15 U.S.C. § 78p(b) (1976). We therefore join the First Circuit in rejecting this argument as specious. *See Grossman v. Johnson, supra*, 674 F.2d at 120.

3. *The Relationship Between Shareholder Demand and the Exercise of the Directors' Business Judgment*

The heart of Weiss' challenge based on the statutory scheme is his assertion that shareholder demand is superfluous because that scheme effectively precludes the Fund's directors from taking action in response to any such demand. The premise of his argument is the Supreme Court's suggestion that the ICA deprives the directors of their authority to exercise their business judgment to terminate a section 36(b) suit. In *Burks v. Lasker, supra*, the Court stated:

> when Congress . . . intended to prevent board action from cutting off deriviative suits, it said so expressly. Section 36(b) . . . performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees.

441 U.S. at 484. Although section 36(b) was not directly at issue in *Burks*, the Court's interpretation of that section influenced its holding that other sections of the ICA do *not* deprive directors of their authority to terminate derivative suits under the shield of the business judgment rule. Prudence dictates that we accede to this strong signal from the Court

that directors may not terminate suits under section 36(b), notwithstanding our perception that the statement's import is unclear. *See infra* pp. 21-22.

Weiss then argues that if a suit's termination is precluded, it would be inconsistent to require demand as a prerequisite to initiation: if directors are too self-interested to be allowed to cut off shareholder suits in the exercise of their business judgment, they must be presumed to be too self-interested to respond objectively to a shareholder demand. Relying in part upon our observation in *Cramer v. General Telephone and Electronics Corp.*, 582 F.2d 259, 274 (3d Cir. 1978). *cert. denied*, 439 U.S. 1129 (1979), that the business judgment rule is "inextricably linked" to the demand requirement, Weiss essentially concludes that the Court's inclination to disregard business judgment in this context makes the demand requirement superfluous and inefficient.

Our opinion in *Lewis v. Curtis*, 671 F.2d 779 (1982), lends some credence to Weiss' position.[12] *Lewis* involved a shareholder complaint alleging that demand would have been futile because the directors had participated in an allegedly self-interested transaction.[13] In evaluating this claim, we stated that the futility of demand turns on the disinterestedness of the directors, not on the nature of the alleged wrongdoing. We also noted that the relevant standard of disinterestedness is the same as that used to determine whether a court should defer to the board's business judgment not to pursue a lawsuit on behalf of the corporation.

> There is no reason why a court, in deciding whether a board is sufficiently interested to excuse demand, should

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12 *Lewis* was published after the briefs in this appeal were filed.

13 The directors were accused of entering into a wasteful settlement agreement with a shareholder. Pursuant to the agreement the shareholder abandoned his proxy contest in which he was seeking a seat on the corporation's board. The complaint also alleged details of a larger scheme by the directors to retain control of the corporation by, among other things, obtaining long-term employment contracts for several directors and reducing the number of directors on the board.

> not be informed by the same factors used to determine whether a court should defer to the board's decision not to pursue the action. The board will lack such disinterestedness if plaintiff's allegations, taken as true, would show that, under state law, a court should not defer to the board's decision not to pursue the lawsuit. . . .
>
> Some courts have suggested that directors may not be sufficiently interested in a transaction to excuse demand, yet are interested enough to be unable to assert the protection of the business judgment rule. . . . On the other hand, formulating different standards for the two issues is . . . difficult. . . . [W]e do not think that we should apply different standards of "interestedness" to cases in which plaintiff has made no demand and to those in which a demand has been made and rejected.

Id. at 785-86 (citations omitted). Since (according to Weiss' argument) directors are too self-interested to terminate shareholder suits, the logical extension of *Lewis* would be to say that they are so interested that demand should be excused in this case as a matter of law.

Although Weiss' argument is superficially alluring, we find it ultimately unpersuasive. First, to the extent that it is based on *Burks*, *see supra* p. 19, the argument rests on rather uncertain footing. Weiss would read *Burks* as standing for the proposition that directors may not terminate shareholder suits because directors are too interested in advisory fee transactions. While this is not an implausible reading of Burks, we do not find the Supreme Court's rationale so easy to discern. Section 36(b)(2) accords the advisory fee actions of directors only "such consideration by the Court as is deemed appropriate under the circumstances." *Burks* understandably concluded that Congress intended less judicial deference to directors' actions regarding advisory fees than is ordinarily associated with the business judgment rule. But we are unable to divine from that opinion a per se rule that investment company directors are presumed to be self-interested, and we decline to adopt Weiss' suggested rule on such a speculative basis.

Weiss also reads too much into our statement in *Cramer, supra*, that the demand requirement and the business judgment rule are "inextricably linked." 582 F.2d at 274. Rather, as the district court noted below, *see* 516 F. Supp. at 670 n.13, the policies underlying each doctrine are distinct.

The demand requirement originated as a judicially-created device that forced shareholders to exhaust intracorporate remedies before beginning suit. As explained in one of the earliest expositions of the principle:

> [I]t is . . . important that before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part.

Hawes v. Oakland, 104 U.S. 450, 460-61 (1882).[14] The requirement reflects judicial cognizance of the prerogatives and expertise of the directors as stewards of the corporate welfare. One commentator summarized this purpose as follows:

> Forcing shareholders to exhaust intracorporate remedies by first making demand on directors allows the directors a chance to occupy their usual status as managers of the corporation's affairs, giving the corporation an opportunity to take control of a suit that will be brought on its behalf. The demand requirement thus furthers a principle basic to corporate organization, that the management of the corporation be entrusted to its board of directors.

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14 The Court's holding in *Hawes* was adopted in 1882 as Equity Rule 94, and was modified in 1912 by Equity Rule 27 to allow allegations of the futility of demand. Equity Rule 27 became Federal Rule of Civil Procedure 23(b) which, in turn, was promulgated as Rule 23.1 in 1966.

Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171 (1976). When faced with a demand by a shareholder, the directors have a number of options. They can exercise their discretion to accept the demand and prosecute the action, to resolve the grievance internally without resort to litigation, or to refuse the demand. It is at this point that the business judgment rule comes into play.

The business judgment rule eludes precise categorization, as it assumes different shapes in different settings. *See* Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 Wash. U.L.Q. 311 (1982). In its traditional form, the rule protects directors from personal liability for business decisions by presuming that they acted in good faith and with reasonable care. *See Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980) (even in a facially self-dealing transaction, the rule assumes directors were "exercising their sound business judgment rather than responding to any personal motivations"), *cert. denied*, 450 U.S. 999 (1981). In shielding directors from the hazards of hindsight challenges to the wisdom of particular decisions, the rule serves two important functions.

> Were courts, with perfect retrospective vision, to second-guess the judgment of officers and directors in their decisionmaking function, they would be injecting themselves into a management role for which they were neither trained nor competent. Such judicial action would also be taking a step to discourage others from performing these desired and essential societal activities. One pragmatic objective of the business judgment rule, then, is to keep courts out of a role they are ill-equipped to perform. Another is to encourage others to assume entrepreneurial and risk-taking activities by protecting them against personal liability when they have performed in good faith and with due care, however unfortunate with consequence. Both are of monumental social utility.

Duesenberg, *supra*, 60 WASH. U.L.Q. at 314 (footnotes omitted).

Because the considerations involved in imposing the demand requirement and invoking the business judgment rule are distinct, their applicability is not necessarily coincidental. In fact, this Court so noted in *Cramer*: "[W]hile the demand requirement of Rule 23.1 should be rigorously enforced, we do not think that the business judgment of the directors should be totally insulated from judicial review."[15] The American Law Institute recently expressed a similar view in its proposed Restatement on Principles of Corporate Governance and Structure § 7.02, at 270-71 (Tent. Draft No. 1, 1982):

> It is not inconsistent for a court to employ a strict standard with respect to the excusal of demand, but then to refuse to accept a decision by the same board of directors to seek termination of the same action. . . . As some decisions have emphasized, the focus at the demand state should be on the issue of whether the corporation may take over the suit and either prosecute it or adopt other internal corrective measures, and not on the later question of whether a decision not to sue should be respected by the court. At the demand stage, the possibility should not be foreclosed that a demand will induce the board to consider issues and crystallize policies which otherwise might not be given attention (e.g., new accounting controls, revised corporate policy statements or even a change in personnel or remuneration). The demand rule can have efficacy even where the board ultimately rejects the action and the court ultimately permits the plaintiff to sue.

In particular, as we noted in *Cramer*, the demand requirement gives management the opportunity to pursue alternative remedies and to avoid unnecessary litigation. 582 F.2d at 275.

We find the distinction particularly important here in light of Congress' clear intent to enhance the independence of directors

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15 At issue in *Cramer* was whether a determination by a disinterested committee of directors that a litigation was not in the best interests of the corporation barred a shareholder suit alleging violations in connection with GTE's foreign payments. The plaintiff had not made a rule 23.1 demand, however, and we affirmed dismissal of the suit on that ground.

and their responsibility for advisory fees. The ICA and its amendments were designed to erase potential conflicts of interest inherent in the structure of investment companies by placing the unaffiliated directors in a substantial management role and providing them with authority to act as checks on advisory fees. Congress explicitly empowered the directors to redress challenges to advisory fees by imposing on directors a duty to evaluate the advisory fees and by authorizing them to terminate investment adviser contacts without penalty upon the giving of sixty days notice. 15 U.S.C. § 80a-15(a)(3)(1976).[16] To allow shareholders to bypass the directors would undermine the role shaped for directors by the ICA. The opportunity to resolve the shareholder grievance without resort to litigation may, in fact, be especially important if the directors are not able to terminate the suit. In that event the Rule 23.1 demand provides the only opportunity for the Fund to avert a lawsuit through internal corrective measures.[17]

Finally, the different purposes served by the business judgment rule and the demand requirement show that the wooden transposition of *Lewis* to this statutory context is inappropriate. *Lewis* was concerned with the futility of demand. It involved an inquiry which is "intensely factual" and requires particularized pleading by the plaintiff. *See Vernars v. Young*, 539 F.2d 966, 968 (3d Cir. 1976). In a conventional shareholder suit, the evaluation of the directors' decision to refuse demand or terminate suit is equally factual, and it makes sense, as we

16 As appellees note, the directors can respond to a timely shareholder demand by (1) negotiating a rebate of fees, (2) satisfying the shareholder that the fees are reasonable in terms of the investment services provided, (3) persuading the shareholder that litigation would adversely affect shareholders' interests, (4) accepting the demand and instituting suit, or (5) refusing the demand.

17 Weiss' argument is also undermined by reference to § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1976) which he invoked in another context. *See supra* pp. 18-19. In a § 16(b) action, where there is no power by the corporation to terminate, *see* Burks v. Lasker, *supra*, 441 U.S. at 484, n.13; *Cramer*, 582 F.2d at 276 n.22, there is an express demand requirement.

stated in *Lewis*, to employ the same standard of interestedness. However, a statutory presumption of interestedness cannot substitute for the factual inquiry needed to determine whether a demand on directors "would be likely to prod them to correct a wrong." *Lewis, supra*, 671 F.2d at 785.[18]

In sum, to read the ICA's statutory scheme as depriving directors of the opportunity to respond to a shareholder grievance would undermine the very purpose of the ICA—to strengthen management of the Fund by its independent directors. We attribute no such inconsistent intent to the Congress and conclude that the demand requirement of Rule 23.1 applies to section 36(b) actions.[19]

IV. THE ALLEGED FUTILITY OF DEMAND

Weiss contends that even if his section 36(b) claim is subject to the Rule 23.1 demand requirement, such demand would have been futile for all counts of his complaint. The complaint alleges that demand is unnecessary because (1) Shearson and the Adviser control and dominate the Fund and its directors; (2) all of the Fund's directors have participated or acquiesced in the Adviser's breach of fiduciary duty; and (3) the hostility of the directors to the claim was evidenced by the filing of an answer to the initial complaint. Amended Complaint at ¶ 37.

The district court found that the allegations of the Adviser's and Shearson's control over the directors were inadequate to excuse demand: Weiss failed to provide proof sufficient to overcome the fact that four of the six directors who approved the transaction were not "interested" under the terms of the

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18 Relying in part on *Lewis*, the Second Circuit suggested in *Fox v. Reich & Tang, supra*, that the demand requirement would serve no function in the § 36(b) context. "[I]t is possible to infer that Congress . . . believed directors would always be so 'interested' that demand would inevitably be 'excused.' " *Id.*, slip op. at n.13. Having already explained our conclusion to the contrary, we simply note the tentative nature of the Second Circuit's language.

19 As noted above, *see supra* p. 14, we must presume that the federal rules apply to this action unless expressly displaced by Congress.

ICA, 15 U.S.C. § 80a-2(a)(19)(1976). The district court also rejected Weiss' effort to use the company's answer to the complaint as evidence of the directors' hostility to suit. Applying the edict of this court that futility "must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight," *see Cramer v. General Telephone & Electronics Corp., supra*, 582 F.2d at 276, the district court concluded that opposition expressed after suit was filed could not excuse demand.

Finally, the court turned to the allegation that the directors' participation in the transaction made demand unnecessary. The court first noted that simply naming the directors as defendants cannot automatically excuse demand on the theory that they would have to decide whether to sue themselves.[20] The court then applied the test enunciated in *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973), which states that mere approval of the challenged transaction is insufficient to demonstrate futility of demand unless the complaint alleges facts showing that the transaction was motivated by self-interest or bias. The Court found that Weiss' complaint failed to allege that the directors stood to gain any personal advantage from approval of the advisory contracts; rather, it challenged the directors' action only as a breach of their statutory and common law fiduciary duties. The court accordingly ruled that the pleadings failed to assert a basis for excusing demand.[21] We agree with the analysis of the district court that these allegations are insufficient to excuse demand and affirm on that basis.

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20 This conclusion was cited with approval in our decision in Lewis v. Curtis, *supra*, 671 F.2d at 785.

21 *Lewis v. Curtis, supra*, which was decided after the district court's decision below, does not mandate a different conclusion. As did *Kauffman, Lewis* held that the futility of demand turns on the interestedness of the directors rather than the nature of the wrongdoing. *See supra* pp. 20-21. Unlike this case, however, *Lewis* involved specific allegations of a self-interested transaction by all the directors. *See* 671 F.2d at 787.

V. DENIAL OF WEISS' MOTION TO REPLEAD AFTER MAKING DEMAND

Finally, Weiss contends that the district court abused its discretion in refusing him leave to replead after a demand on the Fund's directors. He relies principally on *Markowitz v. Brody*, 90 F.R.D. 542 (S.D.N.Y. 1981), in which the court stayed dismissal for ninety days in order to allow plaintiff the opportunity to make a demand.

We reject this contention as well. The law of this circuit makes clear that demand after a complaint has been filed is impermissible since it would "reduce the demand requirement of the rule to a meaningless formality." *Schlensky v. Dorsey*, 574 F.2d 131 (3d Cir. 1978). We recognize that application of this rule in this context may seem costly given the Act's limitation on recovery to the excessive fees received during the year immediately prior to the filing of suit. Nevertheless, requiring demand before the filing of suit affords directors "the opportunity to decide in the first instance whether and in what manner action should be taken." *Id.* A demand after suit is filed would usurp this prerogative.

The district court's judgment dismissing the complaint will be affirmed.

GIBBONS, *Circuit Judge*, dissenting.

This is an appeal from a judgment dismissing a multi-count complaint by a shareholder of a money market fund for failure to comply with the demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure.[1] I agree with the majority that the district court properly dismissed all causes of action pleaded in the complaint except that based upon section 36(b)

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1 The district court's opinion is reported. Weiss v. Temporary Investment Fund, Inc., 516 F. Supp. 665 (D. Del. 1981). Plaintiff also appeals from the court's denial of his subsequent motion for leave to comply with Rule 23.1 and to file an amended complaint. 520 F. Supp. 1098 (D. Del. 1981).

of the Investment Company Act of 1940[2] (ICA). As to that claim I would reverse.

I.

Plaintiff Melvyn I. Weiss, custodian for his son, Gary M. Weiss, is a shareholder of the Temporary Investment Fund, Inc. (Fund), a no-load, open end, diversified investment company, or "money market fund." In 1980, Weiss brought a shareholder's derivative suit against the Fund, the Provident Institutional Management Corp. (Provident), which acts as the Fund's investment adviser, Shearson Loeb Rhoades, Inc. (Shearson), the Fund's underwriter which also performs administrative duties for the Fund, and seven directors of the Fund. Weiss alleges that Provident and Shearson breached their fiduciary duties under section 36(b) of the ICA by receiving excessive and unreasonable compensation for management services. Weiss further alleges that the various defendants participated in or acquiesced in various breaches of fiduciary obligations owed the Fund and in violations of the Securities Exchange Act of 1934,[3] the Banking Act of 1933,[4] the ICA[5] and the common law. The complaint acknowledges that no demand was made on the directors of the Fund to bring a similar action but alleges that such a demand would be futile. The district court, however, concluded that the plaintiff's failure to make such a demand pursuant to Rule 23.1 was fatal to the action, and dismissed it.[6] Subsequently, Weiss filed

2 15 U.S.C. § 80a-35(b)(1976).

3 Specifically Section 14(a), 15 U.S.C. § 78n(a)(1976), and Rule 14a-9, 17 C.F.R. § 240 (1977), adopted thereunder.

4 Specifically Sections 16 and 21, 12 U.S.C. §§ 24 & 378(a)(1976).

5 Specifically Sections 20(a), 1(b)(2), 15(a) and 15(b), 15 U.S.C. §§ 80(a)-1-80a-52.

6 The court also dismissed the complaint as to defendant Robertson for insufficient service of process on him. Plaintiff does not challenge that ruling on appeal, so we leave the court's judgment in that respect undisturbed.

a motion for reargument requesting that the court grant him leave to file an amended complaint after making a demand on the directors. He also asked the court to reconsider its determination of non-compliance with Rule 23.1. The district court refused to reconsider, or to grant leave to make a demand.

II.

Rule 23.1 of the Federal Rules of Civil Procedure specifies several pleading requirements "[i]n a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it . . ." Fed. R. Civ. P. 23.1. Among those requirements is that of pleading that a demand has been made on the directors to enforce a right which the corporation may properly assert.[7] Rule 23.1 finds its genesis in Equity Rule 94, 104 U.S. IX (Jan. 23, 1882), which adopted as an Equity Rule the Supreme Court's holding in *Hawes v. Oakland*, 104 U.S. 450 (1881).[8] The Court in *Haws* stated that

> before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to

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7 The demand requirement of Rule 23.1 reads:

> The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

Fed. R. Civ. P. 23.1.

8 Rule 23.1 was promulgated in 1966. It substantially restated prior Rule 23(b) adopted in 1937 which in turn was a transcription of Equity Rule 27. Equity Rule 27, established in 1912, was itself a slight modification of Equity Rule 94 adopted in 1882. The demand requirement of Equity Rule 94 read:

> [the complaint] must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders, and the causes of his failure to obtain such action.

104 U.S. at X.

> the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court.

104 U.S. at 460-61. This judicially-created demand requirement has survived with slight modification in Rule 23.1. *Hawes* was decided, and Equity Rule 94 was promulgated, during the regime of *Swift v. Tyson*, 41 U.S. (1 Pet.) 1 (1842), when federal courts were free to establish their own equitable remedial jurisprudence. *See* Judiciary Act of 1789, ch. 20, § 11, 1 Stat. 926; Process Act of May 8, 1792, ch. 36, § 2, 1 Stat. 276 (1850). There was, therefore, no need to decide whether Equity Rule 94, with its demand requirement, was substantive law or merely a procedural provision.

Two developments changed that indifference. One was the 1938 merger of law and equity. The other was the Supreme Court's decision in *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945), applying the *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), choice of law to prevent the application of a federal equitable remedial rule in a diversity case. In light of that holding, the procedural or substantive character of the demand requirement of Rule 23.1 becomes important.

It is clear that Congress did not deal with the *Erie* choice of law question with respect to Rule 23.1. The Federal Rules of Civil Procedure were promulgated by the Supreme Court on December 20, 1937 and reported to Congress on January 3, 1938. *Erie v. Tompkins* was argued to the Court on January 31, 1938, and was decided in April 1938. Congress adjourned on June 16, 1938 and the Rules took effect September 16, 1938. That chronology of events makes it highly unlikely that Congress examined the remedial versus procedural aspects of the demand clause in Rule 23.1. The origins of Rule 23.1 are of little help, since, as indicated above, the question in 1882 of whether Rule 23.1 was procedural or substantive need not have

been asked. We are left, therefore, with the task of construing a Federal Rule of Civil Procedure in such a manner as to ensure its validity in actions involving state law claims. *See, e.g., Hanna v. Plumer*, 380 U.S. 460 (1965).

This court has held that a plaintiff-shareholder's obligation to make a demand on the corporate directors before pursuing a derivative claim is inextricably linked to the state law business judgment rule. *Cramer v. GTE Corp.*, 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979). "Once the shareholder has made a demand upon the directors, the directors are then able to determine whether in their opinion a suit on behalf of the corporation would comport with the best interests of the corporation." *Id.* at 275. The directors can pursue remedies alternative to litigation, can terminate meritless causes of action, and can determine whether litigation cost and other adverse effects on business relationships with potential defendants would outweigh any potential recovery from the lawsuit. The directors' decision to allow suit or not is insulated from judicial review by the business judgment rule. The rule is a substantive one, intended to enforce the elected management's responsibility for operating the corporation, while insulating it from liability for good faith mistakes made while performing its duties. *See Briggs v. Spaulding*, 141 U.S. 132, 146-148 (1891).

Subsequent to our decision in *Cramer v. GTE Corp.*, 582 F.2d 259, the Supreme Court had occasion to make explicit what was implicit in the *Cramer* discussion; that the substantive business judgment rule is a rule of state, not federal law. In *Burks v. Lasker*, 441 U.S. 471 (1979), the Court considered whether state or federal law governs the power of a corporation's directors to terminate a derivative suit, and ruled:

> We hold today that federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the [federal statutes relied upon].

Id. at 486.

It is clear, then, that the business judgment rule which Rule 23.1 enforces is not a product of federal substantive law. If the rule is to be considered valid under *Erie*, it must now be regarded as the procedural means whereby federal courts ensure that the underlying substantive state law business judgment rule is implemented. The Rule 23.1 demand requirement is, therefore, a procedural device that since *Erie* is animated by the existence of an underlying substantive content. As a necessary corollary, if it is determined that for a given cause of action the directors do not have the substantive power under the relevant law to prevent or to terminate the derivative action, then the demand requirement of Rule 23.1 is not activated since its application would serve no meaningful purpose. *A fortiori*, if the cause of action is one which the corporation could not bring on its own behalf, Rule 23.1 cannot apply. This is plain from the text of the rule, and would be required as a matter of choice of law in any event.

The issue, thus, is the choice of law to be made in determining whether the underlying cause of action admits to the application of a state law business judgment rule which a Rule 23.1 demand would effectuate. In diversity cases or for pendent state law claims, the relevant substantive law is constitutionally mandated to be state law and, hence, a Rule 23.1 demand requirement is always triggered by the state business judgment rule. In non-diversity cases, *Erie* is of no relevance with respect to the elements of the cause of action. Yet as the Supreme Court makes clear in *Burks v. Lasker*, 441 U.S. 471, federal courts ordinarily look to state corporate law for the existence of an applicable business judgment rule. The federal courts' adoption of state corporate law when deciding the scope of the corporate directors' powers to terminate or to prevent derivative suits is merely a rule of statutory construction. It is based on a judicial determination that Congress in creating federal causes of action does so against a background of state corporate law to which federal courts must refer even though the cause of action is based on federal law. *See Burks v. Lasker*, 441 U.S. at 478-79. *See also Johnson v. Railway Express Agency*, 421 U.S. 454, 465 (1975). That general propo-

sition is qualified, however, by the requirement that the state may not contravene the policies of the federal law with respect to which the business judgment question arises. *See, e.g., Burks v. Lasker*, 441 U.S. at 478-79. The demand requirement under Rule 23.1 is applicable even to federal causes of action because the state law business judgment rule applies unless the relevant federal law preempts exercise of business judgment. A demand is required only if the corporation may assert the cause of action relied upon, and the substantive law giving rise to the cause of action permits the directors to terminate it in the exercise of their business judgment.

III.

For all causes of action asserted by Weiss except that under section 36(b) of the ICA, a demand is required because they depend on state law, or on non-preemptive federal law, and the directors may exercise business judgment to take over or to terminate the claim. Of course, the business judgment rule is inapplicable, as a matter of state law, where the directors' judgment is not in good faith, is the product of self-dealing or is made under the influence of persons suspected of wrongdoing. Moreover, the directors' discretion is not unbounded, and courts may examine their action to determine whether it is within the permissible bounds of that discretion.

Weiss urges that for all counts a demand on the Fund directors should be excused as futile. Like the majority, I am unconvinced. We previously stated that:

> The Supreme Court and, following it, the Courts of Appeals have repeatedly stated and applied the doctrine that a stockholder's derivative action, whether involving corporate refusal to bring anti-trust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that

> their refusal to sue reflects bad faith or breach of trust in some other way.

Landy v. FDIC, 486 F.2d 139, 149 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), *quoting Ash v. International Business Machines, Inc.*, 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966). Weiss' allegations do not, however, state with particularity reasons why the directors would not be able properly to make the choice whether to sue. "Instead of being 'a statement of appropriate and convincing facts' that a demand would have been futile, [plaintiff's allegations constitute] merely a vague, conclusory statement." *Landy v. Federal Deposit Insurance Corporation*, 486 F.2d at 148 (citation omitted). Thus I agree that the District Court did not err in dismissing those state law and federal law claims as to which the state law business judgment rule clearly applies.

IV.

Whether Rule 23.1 applies to a claim asserted under section 36(b) of the ICA depends on (1) whether such a claim is one belonging to the corporation, and (2) if it is, whether it is one as to which the state law business judgment rule may as a matter of federal substantive law apply. Section 36(b) is part of a group of amendments, enacted in 1970, to the Investment Company Act of 1940. Congress decided that mutual funds deserved special regulation because:

> Mutual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, that are separately owned and operated. These separate organizations are usually called investment advisers. The advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees. . . .
>
> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relation-

> ships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

S. Rep. No. 184, 91st Cong., 2d Sess. 5, *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901.

The primary method by which Congress sought to control the peculiar problems of mutual funds was the requirement that at least 40% of fund directors be independent. These "unaffiliated" directors are given the main burden of supervising the management and the finances of the fund. *See Burks v. Lasker,* 441 U.S. at 482-83. In certain areas of the funds' dealings, however, Congress did not leave matters to final resolution by the unaffiliated directors. Rather, it mandated alternative forms of regulation. One area of special concern is the compensation paid by a mutual fund to its adviser. The Senate Report vividly points up that concern:

> In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.
>
> Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means *for the courts to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty.* This bill would make it clear that, as a matter of Federal law, the investment adviser or mutual fund management company has a fiduciary duty with respect to mutual fund shareholders. It provides an effective method whereby *the courts can determine* whether there has been a breach of this duty by the adviser or by

> certain other persons with respect to their compensation from the fund.

S. Rep. No. 184, 91st Cong., 2d Sess. 2, *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4898 (emphasis added). Referring to what is now section 36(b), the Senate Report observes:

> This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees. It does, however, authorize *the court to determine* whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee.
>
> * * *
>
> Directors of the fund, including the independent directors, have an important role in the management fee area. A responsible determination regarding the management fee by the directors including a majority of disinterested directors is not to be ignored. While *the ultimate responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court,* approval of the management fee by the directors and shareholder ratification is to be given such weight as the court deems appropriate in the circumstances of a particular case.
>
> * * *
>
> Under this proposed legislation either the SEC or a shareholder may sue in court on a complaint that a mutual fund's management fees involve a breach of fiduciary duty.

Id. at 4902-03 (emphasis added). This report plainly discloses that while the court must afford deference to the views of fund directors, the ultimate responsibility for deciding whether the fees are so high as to be regarded as a breach of fiduciary duty is judicial. Nowhere in the legislative history of section 36 is there any suggestion that fund directors—even unaffiliated directors—can seek such a judicial determination. Only the

SEC and shareholders are indicated. With that illuminating legislative history in mind we turn to the statute as enacted.

Prior to 1970, section 36 of the ICA authorized the SEC to seek an injunction barring persons in a fiduciary relationship to a fund from acting in such capacity if they were in the five years prior to the action guilty of "gross misconduct or gross abuse of trust." Investment Companies Act of 1940, Pub. L. No. 76-768, § 36, 54 Stat. 841 (1940). No other relief was authorized. In 1970 section 36 was amended to eliminate the "gross misconduct or gross abuse of trust" standard so as to authorize an SEC suit if the fiduciary "has engaged . . . or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company . . . ." 15 U.S.C. § 80a-35(a) (1976). The relief available in an SEC suit was also enlarged so as to permit not only orders barring future participation as a fiduciary, but also "such injunctive or other relief against such person as may be reasonable in the circumstances. . . ."

At the same time an entirely new remedy, dealing specifically with adviser compensation, was added in a new subsection 36(b).[9] It authorizes an action "by the Commission, or by a

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9 Section 36(b) reads:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:
>
> > (1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.
>
> *(footnote continued)*

security holder of such registered investment company, against such investment adviser, . . . for breach of a fiduciary duty in respect of . . . compensation. . . ." 15 U.S.C. § 80a-35(b)(1976).

There are several significant features to the 1970 amendment to section 36. In the 1940 Act, the Section dealt only with SEC enforcement, and the sole remedy was to bar the offender from the investment company industry. Section 36 created no cause of action, express or implied, in favor of a fund. The 1970

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(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

15 U.S.C. § 80a-35(b)(1976).

amendments both carried forward and broadened the SEC enforcement powers in section 36(a). Plainly the "other relief" available under that section would include an accounting which would inure to the benefit of a defrauded fund—not to the SEC. Yet there is no suggestion that the fund could plead a cause of action for the same relief which would be available under section 36(a) in an action by the SEC. As Judge Tyler observed:

> section 36(a) of the Investment Company Act, 15 U.S.C. § 80a-35(a), authorizes the SEC to bring actions against certain individuals or companies for breaches of fiduciary duty involving personal misconduct. Section 36(a), however, authorizes an action by the SEC, not by private individuals. Although this should not be read to prohibit suits by individuals when other sections of the Investment Company Act are violated, when only a general breach of fiduciary duty is alleged, a private suit should more properly be brought in state court.

Monheit v. Carter, 376 F. Supp. 334, 342 (S.D.N.Y. 1974). A section 36(a) action by the SEC may be considered "derivative" in the sense that it may right a wrong committed against a fund, and may even obtain relief in favor of a fund, but it certainly is not "derivative" in the sense that the section 36(a) cause of action belongs to the fund in the first instance. It is only to such a cause of action that Rule 23.1 has any application.

Turning to the new cause of action created in section 36(b) with respect to adviser compensation, we cannot, in determining legislative intention, overlook the significant fact that Congress chose to house it not in a separate provision, but as an amendment to a section which from the beginning dealt with public rather than private enforcement. While Subsection 36(b) does not say in as many words "a state law business judgment rule cannot terminate an action under this section," permitting the directors of a fund to exercise business judgment in order to prevent an SEC action would be inconsistent with the provision that

> [i]n any such action approval by the board of directors of such investment company of such compensation or payments . . . and ratification or approval of such compensation or payments . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances.

15 U.S.C. § 80a-35(b)(2) (1976). Whereas under the typical state law business judgment rule the disinterested directors' decision exercised in good faith binds the court, under section 36(b) the court must make an independent judgment. Moreover, no distinction is made, in this respect, between an action brought by the SEC and one brought by a shareholder. It seems to me, therefore, that by creating the SEC cause of action and the shareholder action in the same sentence, and housing both in a section of the ICA which historically dealt with public rather than private enforcement, Congress disclosed a rather clear intention that the stockholder action be a variety of private attorney general action, *i.e.*, outside the control of the fund's directors. That intention is strongly confirmed by the excerpts from the Senate Report quoted above. It is confirmed, moreover, by the absence of any provision in section 36(a) or (b) for a cause of action by the fund itself.

The majority concludes, despite the absence of any provision in section 36 for a suit by the fund, that the cause of action does belong to the fund, and thus falls within the terms of Rule 23.1. To affirm, the majority must make this assertion, for if the security holders' cause of action is not one which the fund could assert, it is not derivative, at least not in the sense of Rule 23.1. The majority, however, points to no legislative history suggesting that the fund can bring a Section 36(b) suit. I do not believe the omission of a provision for suits by the fund itself was inadvertent. If the fund were authorized to sue, a litigated or, more significantly, a consent judgment would raise serious questions of the preclusive effect of the judgment of any subsequent action by the SEC or a shareholder.[10] The

10 *See* 13 Fletcher Cyc. Corp. § 6043 (Permanent Ed.) and cases cited therein.

most likely interpretation is that Congress intended to create a cause of action solely by the SEC, or by a shareholder acting in a private attorney general capacity, so as to preclude consent judgments entered into by the fund and which might have the effect of precluding the judicial review of director judgment mandated by 15 U.S.C. § 80a-35(b)(2). Such an intention is suggested by legislative history indicating that one of the reasons for expressly allowing suit to be brought by either the SEC or a security holder was the congressional assessment that the fund directors could not effectively deal with adviser compensation. The Senate Report stated that the 1970 amendments to the ICA were predicated on the SEC's 1966 report and recommendations on investment companies. "Public Policy Implication of Investment Company Growth," Report of the Committee on Interstate and Foreign Commerce, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966). In that report, the SEC indicated its judgment that:

> The unaffiliated directors, as the only potentially disinterested persons in the management of most investment companies, can and should play an active role in representing the interests of shareholders not only in connection with management compensation but in other areas where the interests of the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to the protection of public shareholders. *But even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation.*
>
> *The unaffiliated directors are not in a position to bargain on an equal footing with the adviser on matters of such crucial importance to it.* They are not free, as a practical matter, to terminate established management relationships when differences arise over the advisory fees

> or other compensation. This reflects, in large part, the adviser-underwriter permeation of investment company activities to an extent that makes rupture of the existing relationships a difficult and complex step for most companies. *For these reasons, arm's-length bargaining between the unaffiliated directors and the managers on these matters is a wholly unrealistic alternative.*

Id. at 148 (emphasis supplied). It seems unlikely that Congress intended that the unaffiliated directors, by bringing and settling a section 36(b) suit, could accomplish the very result that the SEC regarded as an unrealistic alternative. Thus I do not believe that section 36(b) grants "a right which may properly be asserted by [the fund]." Fed. R. Civ. P. 23.1.

Even if, contrary to its plain language and probable purpose, section 36(b) were to be construed as creating "a right which may properly be asserted by [the fund]," *id.*, there would still remain the question whether the disinterested directors of the fund may, in the exercise of business judgment, prevent a judicial examination, sought by the SEC or a security holder, of advisers fees. Other aspects of the section support a negative answer. There is a one year period of limitation. 15 U.S.C. § 80a-35(b)(3). Such a short period suggests that intervention by fund directors was not contemplated, for if a claim were to be delayed until the directors were notified and were given a chance to consider the advisability of a given action, the statutory period would quickly run out. By adjusting fees prospectively, while delaying the decision on whether to sue for fees already paid, fund managers could significantly reduce recovery. The normal delays incident to corporate decision-making are incompatible with a one year period of limitation, and director involvement therefore must have been discounted by Congress. Another aspect suggesting the inapplicability of the business judgment rule to section 36(b) is the circumscribed nature of a 36(b) cause of action. Recovery is limited to actual damages capped by the total compensation paid. Recovery can only be had from the recipients of compensation, and liability cannot be the predicate for an injunction severing an investment adviser from a fund. These limitations on the section

36(b) remedy minimize the intrusion by the Section upon the directors' responsibility to operate the fund, and suggest the absence of any serious erosion of the management responsibility conferred by state law.

I conclude, therefore, that the Rule 23.1 demand requirement does not apply to a section 36(b) action, because the Section does not provide "a right which may properly be asserted by [the fund]", and because even assuming such a right, section 36(b)(2) preempts any state law business judgment rule which would be furthered by the demand requirement.

This interpretation of section 36(b) has been anticipated by the Supreme Court. In *Burks v. Lasker*, 441 U.S. at 484, the Court stated that:

> [w]hen Congress . . . intend[ed] to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), . . ., 15 U.S.C. § 80a-35(b)(2), added to the [Investment Company] Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees.

The holding in *Burks v. Lasker* that the state law business judgment rule permits independent directors to terminate derivative suits based on federal statutes so long as the rule is consistent with the policies of the federal statutes in issue, puts the quoted statement in context. The application of business judgment to terminate a section 36(b) suit is inconsistent with the policy of that section. The majority treats the statement of the *Burks* Court as a mere *dictum* which this court can disregard. If it is *dictum*, it is *dictum* of the most compelling sort. The quoted passage was not a passing reference, but was integrally tied to the Court's holding and reasoning. The Court supported its position about fund directors' power to terminate other derivative actions by pointing to section 36(b) as an example of Congress, in clear terms, preventing director veto. The *Burks* reasoning depends, therefore, on the quoted *dictum* with respect to section 36(b) and it cannot be disregarded by this intermediate court.

The Court of Appeals for the Second Circuit, which in matters relating to the federal securities law carries particular authority, confronted with the identical problem, reached the same conclusion with respect to section 36(b) as I reach. Moreover it concluded, as I do, that Rule 23.1 is inapplicable because, as *Burks v. Lasker* teaches, it is designed to implement the business judgment rule only in cases where directors can control a lawsuit. *Fox v. Reich & Tang, Inc. and Daily Income Fund, Inc.*, No. 82-7296, slip op. (2d Cir. Oct. 26, 1982).

Despite the unambiguous statement in *Burks v. Lasker* that section 36(b) is an instance in which Congress has precluded the application of any state law business judgment rule, the Court of Appeals for the First Circuit recently affirmed the dismissal of a section 36(b) action for failure to plead compliance with the demand requirement of Rule 23.1. *Grossman v. Johnson*, 674 F.2d 115 (1st Cir. 1982). With deference, I am not persuaded by that court's interpretation of the statute, its treatment of the legislative history, or its reading of *Burks v. Lasker.* Thus while the *Grossman v. Johnson* opinion supports the defendants, I would not follow it. I find particularly unpersuasive the *Grossman* court's treatment of 15 U.S.C. § 80a 35(b)(2)(1976). While acknowledging that the section "can easily be read to give the court, rather than the directors, the ultimate power to decide the propriety of the fees," it reasoned that a demand would not be futile, because the directors' "decision to side with the complainant (entirely or in part) would have important consequences, and even their knowledgable disagreement with the demand might be deemed worthy by the court of grave consideration under § 36(b)(2)." 674 F.2d at 121. Section 36(b)(2) explicitly directs the court to give the directors' views "such consideration . . . as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a 356(b)(2)(1976). Obviously those views can be made known during the course of the lawsuit. But the court's obligation to take the directors' views into account does not, even under the *Grossman* court's analysis permit the directors to terminate or to prohibit the security holders' action. Thus the demand

which that court required served no purpose but to delay judicial inquiry and to insulate more payments to the investment adviser from such judicial review by operation of the short statute of limitations in section 36(b)(3). Since the directors' business judgment is to be considered relevant to a section 36(b) claim only to the limited extent that the court must take the directors' views into account, any state law business judgment rule is clearly supplanted. What must be reconciled is section 36(b)(2) and Rule 23.1. No federal policy suggests itself which would support a mechanistic application of the demand requirement when the only purpose to be served is to give the directors an opportunity to make their views known to the court. That can be done in an appropriate pleading.

The majority's analysis, relying on *Cort v. Ash*, 422 U.S. 66 (1975), is as flawed as that of the *Grossman* court. It must be noted that the *Cort v. Ash* test for implying causes of action in favor of parties not mentioned in a federal statute has been significantly contradicted by subsequent cases such as *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 639 (1981), and *Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n*, 453 U.S. 1, 13 (1981). We must look for a clear indication of congressional intent to afford such a cause of action. Neither the statutory language nor its legislative history contains any such indication of an intent to permit an investment fund to control a section 36(b) claim and thereby insulate it from judicial review. Indeed, as I have outlined above, a contrary intent is the most likely.

Finally, the majority's reliance on *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825 (1982), is an extreme misinterpretation of that authority. The *Curran* case found a congressional intention, when amending the Commodity Exchange Act by the Commodity Futures Trading Act of 1974, to recognize that prior to the amendment lower federal courts had implied causes of action from the former although it did not expressly provide for them. No cause of action had been implied for the entirely new cause of action created in section 36(b) because that cause of action did not exist at the

time Congress last spoke. The suggestion that the *Curran* analysis applies because a fund could bring a common law action against an adviser for corporate waste demonstrates confusion about the nature of the problem which the *Curran* Court addressed. Common law causes of action are not "implied" from federal statutes. They exist as a matter of state law. Moreover, the suggestion ignores the clear intention, in section 36(b), to create a right to recover overcharges which could not be recovered under the state common law of waste.

V.

Since the governing federal law does not permit direct control over section 36(b) actions, it supplants the applicable state law business judgment rule. No section 36(b) policy would be advanced by applying the demand requirement of Rule 23.1 to section 36(b) actions. Absent an underlying substantive rule of law which the pleading requirements of Rule 23.1 would advance, their application serves no useful purpose. The trial court erred, therefore, in dismissing the complaint for failure to plead that a demand had been made on the directors. The judgment appealed from should be affirmed insofar as it dismissed all claims other than that predicated on section 36(b), but reversed insofar as it dismissed that claim.[11] Thus I dissent from the judgment of this court insofar as it affirms the dismissal of the section 36(b) claim.

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11 I also agree that the district court did not abuse its discretion by denying plaintiff leave to make subsequent demand on the directors and to replead.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-2688

MELVYN I. WEISS, Custodian for GARY MICHAEL WEISS, U/NY/UGMA,

Appellant,

—v.—

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES INC., RUSSELL W. RICHIE, ROBERT R. FORTUNE, JAMES LOUIS ROBERTSON, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, G. WILLING PEPPER,

Appellees.

(D.C. Civil No. 80-00230)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF DELAWARE

Present: GIBBONS, SLOVITER and BECKER,
Circuit Judges.

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the District of Delaware and was argued by counsel on April 2, 1982.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, entered August 27, 1981, be, and the same is hereby affirmed. Costs taxed against appellant.

ATTEST:
Chief Deputy Clerk

November 12, 1982

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 81-2688

MELVYN I. WEISS, Custodian for GARY MICHAEL WEISS, U/NY/UGMA,

Appellant,

—v.—

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES, INC., RUSSELL W. RICHIE, ROBERT R. FORTUNE, JAMES LOUIS ROBERTSON, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, G. WILLING PEPPER,

Appellees.

(D.C. Civil No. 80-00230)

SUR PETITION FOR REHEARING

Present: SEITZ, *Chief Judge*,
ALDISERT, ADAMS, GIBBONS, HUNTER, WEIS, GARTH, HIGGINBOTHAM, SLOVITER and BECKER,
Circuit Judges

The petition for rehearing filed by appellant Melvyn I. Weiss in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.
JUDGE GIBBONS would grant rehearing.

By the Court,

/s/ Edward Becker
Judge

Dated: December 30, 1982

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

Civil Action No. 80-230

MELVYN I. WEISS, Custodian for GARY MICHAEL WEISS, U/NY/U.G.M.A.,

Plaintiff,

—against—

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES INC., RUSSELL W. RICHIE, ROBERT I. FORTUNE, JAMES LOUIS ROBERTSON, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, G. WILLING PEPPER,

Defendants.

Joseph A. Rosenthal, Esq., and Kevin Gross, Esq., Morris and Rosenthal, P.A., Wilmington, Delaware; of counsel: Daniel W. Krasner, Esq., and Robert Lewin, Esq., Wolf Haldenstein Adler Freeman & Herz, New York, New York; attorneys for plaintiff.

Rodman Ward, Esq., Skadden, Arps, Slate, Meagher & Flom, Wilmington, Delaware; for defendant Temporary Investment Fund, Inc.

Robert K. Payson, Esq., Potter, Anderson & Corroon, Wilmington, Delaware; Of Counsel: Peter M. Mattoon, Esq., Richard Z. Freemann, Jr., Esq., and John B. Langel, Esq., Ballard, Spahr, Andrews & Ingersoll, Philadelphia, Pennsylvania; attorneys for defendant Provident Institutional Management Corporation.

Charles F. Richards, Jr., Esq., Richards, Layton & Finger, Wilmington, Delaware; Of Counsel: David L. Foster, Esq., Richard E. O'Connell, Esq., and James B. Eisenberg, Esq., Willkie Farr & Gallagher, New York, New York; attorneys for defendant Shearson Loeb Rhoades Inc.

S. Samuel Arsht, Esq., and William T. Allen, Esq., Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware; Of Counsel: Morris R. Brooke, Esq., James M. Sweet, Esq., and James C. Ingram, Drinker Biddle & Reath, Philadelphia, Pennsylvania; attorneys for defendants Richie, Fortune, Robertson, Watts, Jr., Young, Gates and Pepper.

OPINION

Dated: June 17, 1981
Wilmington, Delaware

SCHWARTZ,—District Judge

Plaintiff Melvyn I. Weiss, acting as custodian for his son, Gary M. Weiss (jointly referred to as "Weiss"), is a shareholder of the Temporary Investment Fund, Inc. (the "Fund").[1] The Fund is a no-load, open end, diversified investment company whose objective is to maximize current income consistent with perservation of capital, and is commonly known as a "money market fund." Provident Institutional Management Corporation (the "Adviser"), a wholly owned subsidiary of Provident National Bank ("Provident"), serves as the Fund's investment adviser. Pursuant to a Sub-Advisory Agreement with its subsidiary, the Adviser, Provident National Bank supplies the Fund with all necessary investment advisory services. Shearson Loeb Rhoades, Inc. ("Shearson") is the underwriter for the Fund and, pursuant to an Administration and Distribution

1 All facts are taken from the amended complaint and are presumed true for the purpose of defendants' motions to dismiss.

Agreement (the "Distribution Agreement"), has performed administrative functions for the Fund.

On May 7, 1980, Weiss brought this shareholder's derivative suit against the Fund, the Adviser, Shearson and seven directors of the Fund. In an amended complaint filed on January 7, 1981, Weiss alleges four separate causes of action. First, Weiss alleges that the Adviser and Shearson have breached their fiduciary duty under section 36(b) of the Investment Company Act of 1940[2] (the "Act") in that they have received excessive and unreasonable compensation for the management services they have performed on behalf of the Fund. Second, plaintiff alleges that the Fund's Advisory Agreement and Distribution Agreement are void because they were the product of the directors' breach of their fiduciary duties to the Fund, because the Adviser and Shearson dominated and controlled the conduct of the directors in connection with the approval of the Investment Advisory and Distribution Agreements, and because shareholder approval of the Advisory Agreement was obtained through the use of false and misleading proxy materials. Third, Weiss contends that the Banking Act of 1933 makes it illegal for the Adviser to act as investment adviser to the Fund because it is a wholly owned subsidiary of Provident, a national bank.[3] Finally, Weiss alleges that Shearson has

2 Section 36(b), 15 U.S.C. § 80a-35(b), provides in pertinent part:

> [T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person.

3 Section 21 of the Banking Act of 1933, 12 U.S.C. § 378, subject to certain exceptions enumerated in section 16 of the Act, 12 U.S.C. § 24, makes it unlawful

(footnote continued)

breached its fiduciary duty to the Fund under the Investment Company Act in that it receives several million dollars in compensation per year from the Fund while rendering virtually no services of value to the Fund. The relief sought by Weiss includes a judgment declaring the Advisory Agreement and the Distribution Agreement void, an order requiring that the Adviser and Shearson repay to the Fund all excessive fees paid to them by the Fund, and an order requiring the individual defendants to pay to the Fund damages caused by violations of the Investment Company Act and the Securities Exchange Act.

Now before the Court are various motions to dismiss filed by the defendants. The individual defendants, the Adviser, and Shearson all move to dismiss the complaint for failure to satisfy the demand on directors requirement of Rule 23.1 of the Federal Rules of Civil Procedure.[4] The individual defendants move to dismiss on the grounds that (1) the action created under section 36(b) of the Investment Company Act lies only against recipients of alleged excessive compensation; (2) there is no implied private right of action under sections 1(b) and 15 of the Investment Company Act; and, (3) the Court does not have the power to hear any pendent state claims against the directors. In addition, defendants Gates, Robertson, Pepper and Fortune move to dismiss on the ground that there has been no effective service of process upon them. Shearson moves to dismiss on the ground that there is no cause of action against it under section 36(b) of the Investment

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> [f]or any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor. . . .

4 It is settled in this Circuit that defendants other than the corporation on whose behalf the derivative claim is asserted have standing to raise the defense of failure to comply with the requirements of Rule 23.1. *See* Shlensky v. Dorsey, 574 F.2d 131, 142 (3d Cir. 1978).

Company Act. The Adviser moves to dismiss on the grounds that the complaint does not state an action against it under the Banking Act of 1933, sections 1(b) and 15 of the Investment Company Act, the Bank Holding Company Act, or common law, and the complaint does not satisfy the verification requirements of Rule 23.1. Shearson and the Adviser also move to strike plaintiff's demand for a jury trial.

For the reasons explained below, the Court concludes that plaintiff has failed to satisfy the demand requirement of Rule 23.1. In addition, the complaint must be dismissed as to defendant Robertson because of insufficient service of process. The Court deems it unnecessary to address the scope and existence of the causes of action alleged or the other claims raised in view of its determination that intracorporate remedies should first be exhausted.

I. *The Demand Requirement*

Rule 23.1 of the Federal Rules of Civil Procedure states in pertinent part that a shareholder's derivative complaint shall "allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . . and the reasons for his failure to obtain the action or for not making the effort." The amended complaint states the following reasons for failure to make a demand upon the directors of the Fund to take up the cause of action: (1) derivative claims under section 36(b) are exempt from the demand requirements of Rule 23.1; (2) demand would be futile because Shearson and the Adviser control and dominate the Fund and its directors; (3) demand would be futile because the directors are named as defendants and they participated and/or acquiesced in the wrongs alleged; and, (4) the Fund's filing of an answer seeking dismissal of the suit demonstrates the opposition of the directors to plaintiff's claim and the futility of demand. Amended Complaint, ¶ 37.

Plaintiff has not pointed to any authority which persuades the Court that Congress intended that shareholder derivative actions brought pursuant to section 36(b) of the Investment

Company Act be exempt from the demand requirement. Nothing in the language of section 36(b)[5] expressly excuses demand in actions brought by shareholders under that statute, nor does anything in the legislative history of section 36(b) indicate that Congress intended to eliminate the demand requirement. The legislative materials cited by plaintiff simply make clear the intent of Congress to create a federal cause of action by which security holders of investment companies could judicially challenge excessive compensation paid to investment advisers. Nothing in the legislative history expressly or implicitly reveals a Congressional concern that the demand requirement imposed by the Federal Rules of Civil Procedure was frustrating efforts by shareholders to attack fee provisions of investment advisory contracts. Rather, to the extent that the 1970 amendments sought to eliminate existing hurdles to shareholders' derivative suits challenging investment advisers' fees as excessive, they were intended to eliminate the requirement commonly imposed by the courts that the shareholder establish that payment of the fees constituted a "waste of corporate assets."[6] Although Congress may have considered, and then

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5 *See* note 2, *supra.*

6 *See, e.g.*, S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4901; 115 Cong. Rec. 13,699 (1969) (remarks of Sen. Brooke); *Investment Company Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong., 1st Sess. 19-20 (1969) (testimony of SEC Commissioner Hugh F. Owens).

The leading case applying the doctrine of "corporate waste" to derivative actions challenging investment advisers' fees was Saxe v. Brady, 184 A.2d 602 (Del. Ch. 1962). Under this doctrine, if the stockholders have ratified the investment advisory contract, a derivative suit will succeed only if the plaintiff establishes that "what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid." *Id.* at 610. Application of the corporate waste doctrine virtually insulated investment advisory fees from judicial scrutiny. *See* Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 141-43 (1966).

rejected, the possibility of imposing special procedural requirements on derivative suits under the Investment Company Act,[7] there is no evidence of any Congressional intent to dispense with the preexisting requirements of Rule 23.1 of which Congress was undoubtedly aware.[8]

This conclusion is consistent with other decisions interpreting section 36(b). Two other district courts recently have rejected claims that the demand requirement is inapplicable to actions brought under section 36(b). *See Markowitz v. Brody*, No. 80 Civ. 2602 (RJW), slip op. at 15-18 (S.D.N.Y. May 20, 1981); *Grossman v. Johnson*, No. 77-3015-T, slip op. at 11-13 (D. Mass. April 7, 1981), *following Untermeyer v. Fidelity Daily Income Trust*, 79 F.R.D. 36, 45-46 (D. Mass.), *vacated on other grounds*, 580 F.2d 22 (1st Cir. 1978). Even in *Boyko v. Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y. 1975), upon which plaintiff relies heavily, the court specifically stated that its conclusion that demand on directors in section 36(b) suits will be presumed futile when there is at least one affiliated or

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7 *See Investment Company Amendments of Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong., 1st Sess. 30 (letter of SEC Commissioner Owens opposing suggested requirement that suing shareholder represent either 1% of fund's outstanding shares or $250,000 in net asset value of fund) (1969).

8 Indeed, in responding to a question expressing concern about the potential for nuisance suits under legislation which would authorize shareholders to bring an action against investment advisers, SEC Chairman Budge stated that "there are adequate safeguards under the Federal Rules of Civil Procedures [*sic*] and under this bill to prevent unjustified shareholder litigation." *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. 201 (1969).

The Court also finds unpersuasive Weiss's analogy to section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b). Rather than dispensing with demand, section 16(b), by express language, creates its own demand requirement. *Cf.* Markowitz v. Brody, No. 80 Civ. 2602 (RJW), slip op. at 8-14 (S.D.N.Y. May 20, 1981) (rejecting argument that, by analogy to section 16(b), the contemporaneous ownership requirement of Rule 23.1 should not apply to section 36(b) actions).

interested director on a fund's board should not be "construed as a holding that Rule 23.1 has been in any way abrogated by Section 36(b)." *Id.* at 696. Finally, plaintiff's reliance upon *Burks v. Lasker,* 441 U.S. 471 (1979), is misplaced. In *Burks* the Supreme Court held that under certain circumstances the disinterested directors of an investment company, pursuant to the business judgment rule, may terminate a derivative suit brought under the Investment Company and Investment Advisers Acts against other directors of the company. Although there is dictum in *Burks* to the effect that disinterested directors do not have the power to terminate derivative suits brought under section 36(b),[9] that is not authority for the proposition that demand need not be made on the directors in the first place. As the Court noted in *Burks*, Congress intended that independent directors act as 'watchdogs" who would supply a check on management of investment companies and represent the interests of shareholders; these "watchdogs" were therefore entrusted with "the primary responsibility for looking after the interests of the funds' shareholders." 441 U.S. at 484-85 (footnote omitted).[10] It would be inconsistent with this Congressional scheme to permit shareholders in all instances to initiate derivative actions under section 36(b) without first presenting their claims to the independent directors. The independent directors, consistent with their obligation to represent shareholder interests, might be persuaded to take up the

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9 "And when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), 84 Stat. 1428, 15 U.S.C. § 80a-35(b)(2), added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees. No similar provision exists for derivative suits of the kind involved in this case." 441 U.S. at 484 (footnote omitted).

10 Among the responsibilities assigned to the disinterested directors of mutual funds are review and approval of underwriting and investment advisory contracts, appointment of other disinterested directors to fill certain vacancies on the board, and selection of the fund's accountants. *See* 15 U.S.C. §§ 80a-15(c), 80a-16(b), 80a-31(a); Burks v. Lasker, *supra*, 441 U.S. at 483.

shareholder's claim.[11] The directors, on the other hand, might be in a position to resolve the grievance without litigation,[12] or to persuade the complaining shareholder that the claim is unjustified or that its prosecution would not be in the best interests of the company. *See* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171-72 (1976). Thus, even if the independent directors may not terminate a section 36(b) suit after demand has been made and rejected, the shareholders and the investment company are better served by requiring that demand nonetheless be made unless it is shown that demand would be futile.[13]

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11 It is unsettled whether an investment company may itself bring an action against its adviser under section 36(b). In Boyko v. Reserve Fund, Inc , *supra*, the court reached the questionable conclusion that Congress presumed that the directors of a mutual fund would inevitably be hostile to a section 36(b) action against its investment adviser and therefore did not create such a cause of action in mutual funds themselves. *See* 68 F.R.D. at 695-96 & n.2. By contrast, in Markowitz v. Brody, *supra*, the court ventured in dictum that a private right of action in favor of mutual funds should be implied from section 36(b). Slip op. at 22 n.12. Even if a mutual fund is precluded from suing under section 36(b), however, it may have a common law action against the adviser. *See Untermeyer, supra*, 79 F.R.D. at 45-46 & n.30.

12 The directors' power to terminate unilaterally an investment advisory contract under section 15(a)(3) of the Investment Company Act, 15 U.S.C. § 80a-15(a)(3), would give the board an important bargaining chip in negotiating with the adviser for recovery of excessive compensation.

13 Although it has been stated that the demand requirement is "inextricably linked" to the business judgment rule, Cramer v. General Telephone and Electronics Corp., 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979), it is important to distinguish the analysis appropriate when a court considers whether demand should have been made and that called for when it decides whether a properly initiated derivative suit should be terminated because of the "business judgment" of the corporation's directors that prosecution of the suit would not be in the corporation's interests.

The Rule 23.1 demand requirement is a procedural device intended to further the policy that an individual shareholder ordinarily should not usurp the responsibility of corporate management to determine whether and how to pursue a corporate claim. *See* 3B Moore's Federal Practice ¶ 23.1. 15[4] (2d

II. *Whether Demand Would be Futile*

Having determined that the demand requirement applies to plaintiff's section 36(b) claim, as well as to his other derivative claims, it is now necessary to determine whether demand would have been futile and therefore may be excused.

Weiss alleges in his complaint three reasons in support of his position that demand would be futile: (1) Shearson and the

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ed. 1980). Thus the question of demand and whether it is required is primarily addressed to the issue of *who* will assert a corporate claim—the corporation or a shareholder. A court will excuse demand only when objective facts persuade it that the corporation will not take up the suit or otherwise act to redress the shareholder's grievances. *See, e.g.*, Nussbacher v. Continental Illinois National Bank & Trust Co., 518 F.2d 873, 878-79 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976) (demand excused because directors' opposition to prior, nearly identical lawsuit, was loud and clear message that board would under no circumstances take the action desired by the shareholder).

A decision to excuse demand, however, does not reflect upon the merits of a derivative action, and there will be some cases in which demand is futile, but the corporation is nonetheless able to terminate the suit after it has been properly initiated by the shareholder. Thus in *Nussbacher, supra*, the court observed that its determination that demand was futile did not require resolution of the question whether the board could terminate the action pursuant to the business judgment rule. *See* 518 F.2d at 878. Application of this "business judgment rule" requires reference to state corporation law, which furnished the standards to be applied when the requisite demand has been made or demand has been excused, and the corporation's board of directors seeks to terminate a suit on the ground that the litigation is not in the best interests of the corporation. *See* Burks v. Lasker, *supra*, 441 U.S. at 477-80, 486. If the directors have no interest in the challenged transaction, the courts will generally defer to a good faith decision of the board not to pursue a cause of action. Even if a derivative suit charges a majority of the directors of a corporation with self-dealing or other breach of fiduciary duty, and demand has therefore been excused, the corporation may still move to terminate the action by asserting the "business judgment" of a committee of independent directors that litigation is not in the corporation's best interests. In that case, however, the courts are likely to closely scrutinize a corporate decision to terminate derivative litigation, and the court may indeed be required to apply its own independent business judgment and decide whether litigation is in the corporation's interests. *See, e.g.*, Zapata Corp. v. Maldonado, No. 113-1980, slip op. at 28 (Del. May 13, 1981); *Cramer, supra*, 582 F.2d at 275.

Adviser control and dominate the Fund and its directors; (2) the directors have knowingly acquiesced in the transactions complained of; and, (3) the directors have made clear their opposition to plaintiff's claim by causing the Fund to file an answer asserting that plaintiff's claims lack merit.

A.

Weiss alleges that demand would be futile because the Adviser and Shearson "control and dominate" the directors. Yet, it is uncontested that at the time the original complaint was filed four of the Fund's six directors were "disinterested persons" under the Investment Company Act.[14] Thus, when this action was commenced, a majority of the Fund's board of directors was composed of those persons entrusted by Congress with "responsibility for looking after the interests of the [Fund's] shareholders." *Burks v. Lasker, supra*, 441 U.S. at 485 (footnote omitted). Weiss offers no factual support for his assertion that these independent directors are controlled and dominated by the Adviser and Shearson and would therefore be unable to fairly weigh the merits of his claims. Instead, Weiss offers the conclusory statement, without supporting facts, that the directors "were selected for their positions by Shearson and the Adviser and they are beholden to them for their directorial offices with the Fund and consider their directorial offices with the Fund a matter of great value and prestige in the business community." Amended Complaint, ¶ 37(c). The question whether a director is controlled by a third party, however, is "an intensely factual one," and Rule 23.1

14 A seventh director, also not an "interested person," was elected after the complaint was filed. *See* Doc. No. 17 at 5. Section 10(a) of the Investment Company Act, 15 U.S.C. § 80a-10(a), requires that no more than 60% of the members of the board of an investment company be "interested persons" of the company. The class of "interested persons" is very broad and includes virtually anyone with a financial, employment, or personal connection with an investment company or its investment adviser, any broker or dealer registered under the Securities Exchange Act of 1934, and any person affiliated with such a broker or dealer. *See* section 2(a)(19) of the Act, 15 U.S.C. § 80a-2(a)(19).

requires that a plaintiff "assert the facts from which it is believed an inference of control could be drawn." *Vernars v. Young*, 539 F.2d 966, 968 (3d Cir. 1976).[15] A recent case, also involving claims that a mutual fund paid its investment adviser excessive compensation, rejected as inadequate a similar conclusory allegation that a board of directors with a majority of independent directors was controlled and dominated by the fund's investment adviser. *See Grossman v. Johnson*, *supra*, slip op. at 8; *accord Jones v. Equitable Life Assurance Society*, 409 F. Supp. 370, 373 (S.D.N.Y. 1975); *Kusner v. First Pennsylvania Corp.*, 395 F. Supp. 276, 284-85 (E.D. Pa. 1975), *rev'd on other grounds*, 531 F.2d 1234 (3d Cir. 1976). Since Weiss has pleaded no specific facts from which the Court may infer that the Fund's board of directors is controlled by either the Adviser or Shearson, that is no basis for excusing demand.[16]

B.

The next asserted ground for excusing demand is the allegation that the directors participated in and approved of the transactions at issue and are themselves named as defendants. In particular, the complaint alleges that the directors gave "rubber stamp" approval to the Advisory and Distribution Agreements (¶ 22), that they approved the Advisory Agree-

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15 *Cf. Cramer, supra*, 582 F.2d at 276-77 (when 10 directors were not involved in alleged fraudulent activities, no basis for concluding they were dominated by four director-defendants).

16 The Court declines to follow the conclusion in Boyko v. Reserve Fund, Inc., *supra*, 68 F.R.D. at 696-97, that futility of demand should be presumed whenever there is at least one interested director on a mutual fund's board. The decision in *Boyko* rested on the determination that "Congress assumed that the directors of the investment company would be antagonistic toward, and unlikely to prosecute, an action against the Fund's advisors for breach of fiduciary duty with respect to the receipt of compensation." *Id.* at 696. This reading of the legislative history, however, is inconsistent with that of the Supreme Court in Burks v. Lasker, *supra*, in which the Court found no basis for presuming that the independent "watchdog" directors "could never be 'disinterested' where their codirectors or investment advisers were concerned." 441 U.S. at 485 n.15.

ment even though they knew the Adviser was receiving 25% of the advisory fees after having subcontracted out all advisory functions (¶ 24), and that the directors solicited shareholder approval of the advisory agreement with proxy materials containing a false and misleading statement (¶ 26).

Notably, the complaint does not allege that the directors, in approving the Advisory and Distribution Agreements, were engaged in any kind of self-dealing or otherwise stood to obtain any personal advantage from approval of these contracts. Rather, the core of the allegations against the directors is that they breached statutory and common law fiduciary duties to the shareholders by approving contracts requiring payment of excessive fees for investment advisory services. The weight of legal authority convinces me that such allegations of approval of or acquiescence in the transactions challenged do not excuse demand upon the directors.

The leading case on the question of whether demand is required on directors who have approved or acquiesced in the challenged transaction is *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). In *Kauffman* a shareholder of four mutual funds alleged that the directors of the funds conspired with the funds, their advisers and others to set excessive and noncompetitive management fees in violation of the antitrust laws. The court concluded that demand should not be excused "[w]here mere approval of the corporate action, absent self-interest or other indication of bias, is the sole basis for establishing the directors' 'wrongdoing'. . . ." *Id.* at 265. Since the directors' decisions regarding selection and compensation of investment advisers were directed to a legitimate corporate purpose, and not tainted by any self-interest or other personal bias, there was no basis for conclusively presuming that demand on the independent directors would be futile. *Id.* at 266. A number of other cases have held that approval by independent directors of investment advisers' fees,[17] or of other corporate trans-

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17 *See, e.g.*, Grossman v. Johnson, *supra*, slip op. at 8; Jones v. Equitable Life Assurance Society, *supra*, 409 F.Supp. at 373-74; Kusner v. First Pennsylvania Corp., *supra*, 395 F.Supp. at 284-85; *but see* Papilsky v.

(footnote continued)

actions,[18] will not necessarily prevent the board of directors from giving fair consideration to a shareholder grievance about the transaction. The Court is not faced with the issue of whether Weiss could pursue his derivative claim were he to make a demand upon the board and then have it refused.[19] It is clear however, that the complaint does not allege facts upon which the Court may conclusively presume that the independent directors would not give fair consideration to plaintiff's claims and would refuse to take up the action or otherwise act to redress his grievances.

Finally, the fact that Weiss has named the directors as individual defendants is an inadequate excuse for having failed to make the demand required by Rule 23.1. The prevailing rule is that the mere naming of the disinterested directors as defendants, without pleading facts showing the directors' self-interest or other bias, does not excuse demand.[20] In noting that naming independent directors of a mutual fund as defendants is often a "bootstrap" attempt to avoid the demand requirement of Rule 23.1, Judge Gurfein observed:

> I cannot agree that the mere naming of an unaffiliated director, who is charged with approving a challenged

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Berndt, 59 F.R.D. 95, 97 (S.D.N.Y. 1973), *appeal dismissed*, 503 F.2d 554 (2d Cir.), *cert. denied*, 419 U.S. 1048 (1974).

18 *See, e.g.*, Lewis v. Valley, 476 F.Supp. 62, 64 (S.D.N.Y. 1979) (approval of executive compensation and stock option plans); Brooks v. American Export Industries, Inc., 68 F.R.D. 506, 511 (S.D.N.Y. 1975) (approval of management contract).

19 *Compare* Markowitz v. Brody, *supra*, slip op. at 30 (directors who reject demand may not terminate a shareholder's derivative action under section 36(b)), *with* Grossman v. Johnson, *supra*, slip op. at 13-22 (independent directors may terminate shareholder's section 36(b) action pursuant to business judgment rule).

20 *See, e.g.*, Heit v. Baird, 567 F.2d 1157, 1162 (1st Cir. 1977); Lewis v. Valley, *supra*, 476 F.Supp. at 64; Untermeyer v. Fidelity Daily Income Trust, *supra*, 79 F.R.D. at 42-43; Brooks v. American Export Industries, Inc., *supra*, 68 F.R.D. at 511; Kusner v. First Pennsylvania Corporation, *supra*, 395 F.Supp. at 284-85; Jones v. Equitable Life Assurance Society, *supra*, 409 F.Supp. at 373-74; Phillips v. Bradford, 62 F.R.D. 681, 688 (S.D.N.Y. 1974).

> transaction, can create an irrebuttable presumption that he would not entertain a claim for relief against others. It is not for the plaintiff herself to build a wall around the unaffiliated director of a mutual fund, and then tell him he cannot jump over it. In short, merely naming the directors as defendants does not establish that a demand would have been futile.

Phillips v. Bradford, 62 F.R.D. 681, 688 (S.D.N.Y. 1974). In this case as well, one may fairly infer that the directors were named as defendants only in the hope that demand would thereby be excused. For example, plaintiff takes the position that the elements of proof in the claims against the directors are coextensive with the proof required for the section 36(b) claims against the Adviser and Shearson.[21] Assuming, however, that Weiss could prove his claims against the Adviser and Shearson, parties whose ability to fully satisfy any judgment has not been questioned, no further monetary recovery could inure to the corporation by pursuing a questionable implied cause of action against the directors. The tactic of naming the directors as defendants, in the circumstances of this case, is an insufficient basis for excusing demand.

C.

Finally, Weiss argues that the Fund's answer to his original complaint, in which the Fund asserts that plaintiff's allegations lack merit, demonstrates the hostility of the directors to his claims and the futility of demand. It is true that clear evidence of the directors' opposition to an action urged by a shareholder will in some circumstances excuse demand. *See, e.g., Nussbacher v. Continental Illinois National Bank & Trust Co.*, 518 F.2d 873, 878-79 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976); Note, *supra*, 44 U. Chi. L. Rev. at 180-82. Plaintiff, however, ignores the rule in this Circuit that "[t]he futility of making the demand required by Rule 23.1 must be gauged at

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21 *See* Plaintiff's Memorandum of Law in Opposition to Defendants' Motions (Doc. No. 28) at 22.

the time the derivative action is commenced, not afterward with the benefit of hindsight." *Cramer v. General Telephone & Electronics Corp., supra,* 582 F.2d at 276. In *Cramer* the board's expression of opposition to a derivative action after it had been filed was insufficient to excuse demand. Likewise, since the directors of the Fund expressed their opposition to Weiss' suit only after it was filed, that is not a basis for excusing demand.

III. *Service of Process*

Defendants Gates, Robertson, Pepper and Fortune contend, and plaintiff does not dispute, that the service on May 8, 1980, of process directed to them on Michael J. Robinson, Vice-President and Treasurer of the Fund, was not effected in a manner authorized by Rule 4(d) of the Federal Rules of Civil Procedure. The record, however, indicates that subsequent to the filing of the motions to dismiss, defendants Gates, Pepper and Fortune have been served with summons and the amended complaint in a manner authorized by Rule 4(d). Therefore, as to them, the motion to dismiss for insufficiency of service of process will be denied. *See Consolidation Coal Co. v. Disabled Miners of Southern West Virginia,* 442 F.2d 1261, 1267-68 (4th Cir.), *cert. denied,* 404 U.S. 911 (1971). There is no indication in the record that Robertson has been effectively served, and therefore the complaint must be dismissed as to him because Robinson was not authorized by either Rule 4(d) or Delaware law to receive process on his behalf.[22]

Conclusion

An order will be entered dismissing the complaint for failure to satisfy the requirements of Rule 23.1 and dismissing the complaint as to defendant Robertson for ineffective service of process.

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22 10 *Del. Code* §§ 3104 & 3114, which authorize service of process on certain nonresidents, require that such service be made either on the Secretary of State, or in the case of a corporate director, on the corporation's registered agent.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

Civil Action No. 80-230

MELVYN I. WEISS, Custodian for GARY MICHAEL WEISS, U/NY/UGMA,

Plaintiff,

—v.—

TEMPORARY INVESTMENT FUND, INC., et al.

Defendants.

ORDER

At Wilmington this 17th day of June, 1981, for the reasons set forth in the accompanying Opinion issued this date,

IT IS ORDERED THAT:

1. The complaint is dismissed for failure to satisfy the requirements of Rule 23.1 of the Federal Rules of Civil Procedure; and

2. The complaint is dismissed as to defendant Robertson for ineffective service of process.

/s/ Murray M. Schwartz
United States District Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

Civil Action No. 80-230

MELVYN I. WEISS, Custodian for GARY MICHAEL WEISS, U/NY/U.G.M.A.,

Plaintiff,

—against—

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES INC., RUSSELL W. RICHIE, ROBERT R. FORTUNE, JAMES LOUIS ROBERTSON, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, G. WILLING PEPPER,

Defendants.

Joseph A. Rosenthal, Esq., and Kevin Gross, Esq., Morris and Rosenthal, P.A., Wilmington, Delaware; of counsel: Daniel W. Krasner, Esq., and Robert Lewin, Esq., Wolf Haldenstein Adler Freeman & Herz, New York, New York; attorneys for plaintiff.

Rodman Ward, Esq., Skadden, Arps, Slate, Meagher & Flom, Wilmington, Delaware; for defendant Temporary Investment Fund, Inc.

Robert K. Payson, Esq., Potter, Anderson & Corroon, Wilmington, Delaware; Of Counsel: Peter M. Mattoon, Esq., Richard Z. Freemann, Jr., Esq., and John B. Langel, Esq., Ballard, Spahr, Andrews & Ingersoll, Philadelphia, Pennsylva-

nia; attorneys for defendant Provident Institutional Management Corporation.

Charles F. Richards, Jr., Esq., Richards, Layton & Finger, Wilmington, Delaware; Of Counsel: David L. Foster, Esq., Richard E. O'Connell, Esq., and James B. Eisenberg, Esq., Willkie Farr & Gallagher, New York, New York; attorneys for defendant Shearson Loeb Rhoades Inc.

S. Samuel Arsht, Esq., and William T. Allen, Esq., Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware; Of Counsel: Morris R. Brooke, Esq., James M. Sweet, Esq., and James C. Ingram, Drinker Biddle & Reath, Philadelphia, Pennsylvania; attorneys for defendants Richie, Fortune, Robertson, Watts, Jr., Young, Gates and Pepper.

OPINION

Dated: August 27, 1981
Wilmington, Delaware

SCHWARTZ, District Judge

This is a shareholder's derivative action brought on behalf of a money market fund against the fund's investment adviser, its underwriter, and certain members of the fund's board of directors. In an Opinion and Order dated June 17, 1981, the Court dismissed the complaint for failure to satisfy the demand on directors requirement of Rule 23.1 of the Federal Rules of Civil Procedure. On June 26, 1981, plaintiff filed a motion for reargument, which presented three issues for reconsideration by the Court. The first point raised was a request that the Court grant plaintiff leave to make a demand on the directors of the fund and to then file an amended complaint if the demand were refused, while the second and third points sought to have the Court reconsider its determination that plaintiff had not alleged facts sufficient to demonstrate that demand on the fund's directors would have been futile. Because the Court concluded that the arguments raised relating to the futility of demand had been considered and disposed of in the Opinion of June 17, counsel were requested to submit

June 17, counsel were requested to submit memoranda of law limited to the question of whether plaintiff should be allowed to make a demand and file an amended complaint if that demand is refused. This Opinion will address that issue.

Plaintiff has pointed to a number of cases in which district courts have dismissed derivative complaints for failure to satisfy the demand requirement, but have, without elaboration, granted leave for the filing of an amended complaint should the plaintiff then make a demand and have it refused by the corporation's board. *See, e.g., Brody v. Chemical Bank,* 482 F.2d 1111, 1114 (2d Cir. 1973), *on remand,* 66 F.R.D. 87, 90 (S.D.N.Y. 1974); *Siegal v. Merrick,* 84 F.R.D. 106, 110 (S.D.N.Y. 1979); *Markowitz v. Brody,* No. 80 Civ. 2602 (RJW), slip op. at 31 (S.D.N.Y. May 20, 1981). Notwithstanding the decisions in these cases, prior authority in this circuit persuades me that plaintiff's request for leave to file an amended complaint after an anticipated unsuccessful demand must be denied.

The two leading Third Circuit cases analyzing the demand requirement are *Cramer v. General Telephone and Electronics Corp.,* 582 F.2d 259 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129 (1979), and *Shlensky v. Dorsey,* 574 F.2d 131 (3d Cir. 1978). In *Cramer* the court upheld the dismissal of a derivative complaint, holding that the plaintiff had not alleged facts showing that demand would have been futile at the time the action was filed. The court found insignificant that after the complaint was filed a Special Litigation Committee of the board of directors advised GTE's general counsel that the claims were meritless and should not be prosecuted on the company's behalf. The board's opposition to Cramer's suit was immaterial because "[t]he futility of making the demand required by Rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight." 582 F.2d at 276.[1] The court went on to state that unless a derivative

1 To the extent that Landy v. Federal Deposit Insurance Corp., 436 F.2d 139, 150-52 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974), may be read to permit a court to take into account post-complaint events when determining the futility of demand, *Cramer,* the later case, is controlling.

"plaintiff's complaint alleges some facts tending to show why a demand would be futile, such a demand should be required, and the complaint should be dismissed," *id.* at 277 n.23, without suggesting that a plaintiff whose complaint does not satisfy Rule 23.1 should be given leave to make a belated demand and file an amended complaint if the demand is refused.

The suggested procedure of permitting an amended complaint to be filed if demand is now made and refused would seem to be foreclosed by the decision in *Shlensky v. Dorsey.* In *Shlensky* the court rejected plaintiff's contention that the district court erred in refusing permission to amend or supplement the complaint to include reference to "demand letters" written by some of the plaintiffs to members of the board after the filing of their complaints. Rather, the court held that "[t]he contemplated showing of demand made upon the directors after the filing of the shareholders' derivative complaints could not have satisfied the demand requirement of the rule." 574 F.2d at 141. The court observed that such a belated demand would not have given the directors the opportunity to determine in the first instance whether and in what manner to take action. According to the court, "[t]o hold that demands to satisfy Rule 23.1 may be made on the directors after a derivative suit has been initiated would be to reduce the demand requirement of the rule to a meaningless formality." *Id.* at 142.

In this case plaintiff seeks the opportunity to make such a post-complaint demand. My reading of the above cases compels me to conclude that such a procedure would not meet the requirements of the Rule 23.1, as interpreted by the Third Circuit Court of Appeals. *Cramer* and *Shlensky* indicate that the law in this circuit is that a derivative suit which is flawed at its filing by reason of failure to comply with Rule 23.1 cannot go forward. The suit's pendency while intracorporate remedies are being exhausted would itself be contrary to the principle that the directors ordinarily have the responsibility of making the initial decision about whether to bring suit. Moreover, the function of a demand is not only to give the directors the opportunity to consider whether litigation is in the corpora-

tion's interests, but also to permit them to attempt to resolve the shareholder's grievance without litigation. It would be difficult for the Court to gauge in any particular case how much time should reasonably be allotted to these intracorporate measures. Thus I conclude that this action must be finally dismissed. To the extent that plaintiff may be prejudiced by the necessity of filing a new lawsuit should his demand efforts be unsatisfactory,[2] that prejudice is the price to be paid for failing to adhere to the requirements of Rule 23.1 in the first instance.

The motion for reargument will in all respects be denied.

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2 Plaintiff suggests in his Motion for Reargument (Doc. No. 68) that because of the one-year statute of limitations applicable to actions under section 36(b) of the Investment Company Act, 15 U.S.C. § 80a-35(b), many of the claims presented in the instant action would be time-barred in any subsequent suit.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

Civil Action No. 80-230

MELVYN I. WEISS, Custodian for GARY MICHAEL WEISS, U/NY/UGMA,

Plaintiff,

—v.—

TEMPORARY INVESTMENT FUND, INC., et al.,

Defendants.

ORDER

At Wilmington this 27th day of August, 1981, for the reasons stated in the accompanying opinion issued this date,

IT IS ORDERED that plaintiff's motion for reargument is denied.

/s/ Murrary M. Schwartz
United States District Judge

PROVISIONS OF SECTION 36(b)
INVESTMENT COMPANY ACT OF 1940

Section 36(b).

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or

payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this title, or rules, regulations or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this title for the purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, or section 203 of title II of this Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

PROVISIONS OF RULE 23.1
FEDERAL RULES OF CIVIL PROCEDURE

Rule 23.1 Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.